S. HRG. 99-838

THE 1986 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

NINETY-NINTH CONGRESS

SECOND SESSION

FEBRUARY 6 AND 20, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

60-987 O WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

J841-30

60-987 O - 86 - 1

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Congress)

HOUSE OF REPRESENTATIVES

DAVID R. OBEY, Wisconsin, *Chairman*
LEE H. HAMILTON, Indiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
JAMES H. SCHEUER, New York
FORTNEY H. (PETE) STARK, California
CHALMERS P. WYLIE, Ohio
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine
BOBBI FIEDLER, California

SENATE

JAMES ABDNOR, South Dakota, *Vice Chairman*
WILLIAM V. ROTH, Jr., Delaware
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
PETE WILSON, California
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

SCOTT LILLY, *Executive Director*
ROBERT J. TOSTERUD, *Deputy Director*

CONTENTS

WITNESSES AND STATEMENTS

THURSDAY, FEBRUARY 6, 1986

	Page
Obey, Hon. David R., chairman of the Joint Economic Committee: Opening statement	1
Scheuer, Hon. James H., member of the Joint Economic Committee: Opening statement	3
Lungren, Hon. Daniel E., member of the Joint Economic Committee: Opening statement	3
Wylie, Hon. Chalmers P., member of the Joint Economic Committee: Opening statement	4
Mitchell, Hon. Parren J., member of the Joint Economic Committee: Opening statement	5
D'Amato, Hon. Alfonse M., member of the Joint Economic Committee: Opening statement	6
Sprinkel, Hon. Beryl W., Chairman, Council of Economic Advisers, accompanied by Thomas G. Moore, member	11
Chimerine, Lawrence, chairman and chief economist, Chase Econometrics	49
Greenspan, Alan, president, Townsend-Greenspan & Co., Inc	72
Thurow, Lester, professor of economics, Massachusetts Institute of Technology	78

THURSDAY, FEBRUARY 20, 1986

Obey, Hon. David R., chairman of the Joint Economic Committee: Opening statement	95
Lungren, Hon. Daniel, E., member of the Joint Economic Committee: Opening statement	99
Scheuer, Hon. James H., member of the Joint Economic Committee: Opening statement	121
Mattingly, Hon. Mack, member of the Joint Economic Committee: Opening statement	124
Baker, Hon. James A., III, Secretary of the Treasury	101

SUBMISSIONS FOR THE RECORD

THURSDAY, FEBRUARY 6, 1986

Abdnor, Hon. James: Written opening statement	8
Chimerine, Lawrence: Prepared statement	56
Greenspan, Alan: Prepared statement	75
Sprinkel, Hon. Beryl W., et al.:	
Prepared statement	17
Response to additional written questions posed by Representative Scheuer	89

THURSDAY, FEBRUARY 20, 1986

Baker, Hon. James A., III:	
Prepared statement	104
Response to Representative Obey's request to supply the composition of domestic Federal programs that comprise the estimated $418 billion total for fiscal year 1987	114

Page

Baker, Hon. James A., III—Continued
Submission reconciling the differing points of view expressed by Representative Obey and Secretary Baker on the discussion about foreign aid spending 118
D'Amato, Hon. Alfonse M.: Written opening statement 128

THE 1986 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 6, 1986

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 11:40 a.m., in room 2358, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Mitchell, Scheuer, Wylie, and Lungren; and Senator D'Amato.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. We are pleased to have here this morning two members of the President's Council of Economic Advisers.

I should say, given our concerns 1 year ago, I am pleased that we have a witness from the Council of Economic Advisers, period. We were concerned at that time that there was some talk, as you know, that there might not be anybody appointed, and this committee, given its parallel roots with the Council, was more than a little disturbed at those rumors, and we are happy that they weren't correct.

We have with us the Honorable Beryl Sprinkel, Chairman of the Council, and Mr. Thomas G. Moore, who is a member of the Council.

They will be followed by a panel of private economists—Mr. Lawrence Chimerine, chief economist at Chase Econometrics; Mr. Alan Greenspan, president of Townsend-Greenspan & Co., Inc., and former Chairman of the Council when I first came to Congress; and Lester Thurow, professor of economics at MIT.

Only a few months ago—if I could just make a few remarks before the Chairman makes his statement—only a few months ago the President signed the Gramm-Rudman budget process for this year, and only a few minutes ago the President signed the 1986 Economic Report, about which we will hear in just a few moments. And our first two witnesses have come directly from that signing at the White House to present the economic report to this committee, as required by the Employment Act of 1946.

And I think it is safe to say that this year we are operating under the most radical change in the way we formulate fiscal policy since the Council of Economic Advisers and this committee were created 40 years ago.

Under the new Gramm-Rudman legislation, spending and taxing policies will be controlled by statute, based on economic forecasts of the White House and the Congressional Budget Office. The level of deficit reduction required in any given year under the 5-year track which we are now on under Gramm-Rudman will be determined by whether people like our two witnesses believe it will be a good year or a bad year. If they believe it is going to be a good year, with new jobs and rising income and mounting corporate profits and everything we hope for, the revenue coffers at Treasury will swell and less spending cuts or tax increases would be necessary to achieve the so-called maximum deficit amount that Gramm-Rudman stipulates.

On the other hand, a forecast of slow growth would mean that either deep spending cuts or sharp increases in revenues would be required.

Under the economic forecast contained in the report being presented today and the budget assumptions put forward by the administration yesterday, current spending and tax policies would result in roughly a $180 billion deficit in fiscal 1987.

If the forecast and budget assumptions are accurate, either spending or tax policy would have to be altered to achieve a roughly $38 billion deficit reduction. The estimate of real growth in GNP, which this administration places at 4 percent for 1986 and 1987, has a remarkable impact on what changes in fiscal policy would be required under Gramm-Rudman.

If economic policies, for instance, were to be projected at less than 2.5 percent, which has roughly been the average over the past 5 years in terms of growth, the required deficit reduction would not be $38 to $40 billion but rather well over $70 billion, nearly twice the deficit reduction that would be required as a result of the forecast which we are receiving here today.

I find it ironic that while some of the economists for years have been asking that we pay more attention to their numbers, there is now a serious question that we may be having to pay too much attention to people's projections. We would like to hear from our witnesses today about how accurate the economic forecasts have been in the past, how accurate they think the forecasts will be.

My numbers indicate that the administration's February current year forecast has missed the mark on average by about 1.8 percent over the years and that the second year forecast has missed the mark by even larger amounts, and I guess, Mr. Sprinkel, what my main concern is, is this:

We have never had a year when your numbers are more important. We have never had a year when it is more crucial that your numbers be correct because if we proceed on the basis of your numbers and they wind up being off the mark by just the average amount that they have been off by your or any other administration, we would wind up having to totally redo within about a 1-month period what it will probably take us 6 months to do in the regular budget process.

That would mean, in my judgment, not only a budget process chaos on the Hill; I think it would mean massive confusion on a double track all around the country, and it would mean that—for instance, if we were to achieve, say, 2.5 percent real growth or so

rather than the 4 percent you project, that we could be facing substantial sequestration, even if the President's budget were adopted by the Congress in its entirety.

So those are my concerns, and I guess the questions that are raised by Gramm-Rudman would follow roughly along these lines:

Have we concocted an approach to fiscal policy that expects too much of economic forecasting?

It is always easy to be accurate when you are looking backward, but what assurances do we have that we really have the tools to estimate with the degree of accuracy Gramm-Rudman implies what our economic growth is going to be down the line?

What do we need to do to ensure greater accuracy in the economic forecasts?

And it also raises the other obvious question, which is that this system will force greater fiscal restraint in periods of projected weak growth and less restraint in periods of rapid economic growth, which is the opposite in my view of what is required and, I think, many other economists around the country. Those are my concerns.

Mr. Sprinkel, why don't you proceed to address them?

Representative SCHEUER. Can I say a word?

Representative OBEY. Surely.

OPENING STATEMENT OF REPRESENTATIVE SCHEUER

Representative SCHEUER. Thank you very much, Mr. Chairman. I will be very, very brief. We are eager to hear the witnesses.

The one thing that struck me as I thumbed through this report was that there was no statement of the question of productivity in our country and our ability to compete successfully as significant players in global competition, and I was wondering why that very important area of our economy was overlooked.

It is the whole business of deindustrializing America, the problems that our smokestack industries, our production—the sector of our economy that is involved in production is having, the drift of jobs from comparatively high paid production jobs to comparatively low paid service jobs, flipping hamburgers and so forth.

And I wonder if there is any explanation as to why that has been left out.

I look forward to your testimony.

Representative OBEY. Mr. Sprinkel, all I can say is I hope to God your numbers are accurate because if they are not all hell is going to break loose along about August.

Congressman Lungren, did you have anything you wanted to say before Mr. Sprinkel proceeds?

OPENING STATEMENT OF REPRESENTATIVE LUNGREN

Representative LUNGREN. Yes. Thank you, Mr. Chairman. It is a pleasure for me to join in welcoming Mr. Sprinkel before us.

For months I guess we have heard a lot of gloom and doom about, first, what would happen if Congress didn't pass Gramm-Rudman, and now we have been hearing gloom and doom since Congress did pass Gramm-Rudman.

We have heard about calamity after calamity and how the Defense Department was going to be stripped of everything it had and the social programs were going to be stripped and the Coast Guard was no longer going to be able to defend us, the FBI wouldn't have people to follow those who should be followed, and all those sorts of things.

With the economic projections that apparently are coming out now and with at least what I see to be the coming together of these projections on the side of the executive and the legislative branch, it appears that things are not quite as dire as they were just a couple of months ago.

We are talking about budget deficits of 178 billion in fiscal 1987, 164 in 1988, 146 in 1989, 123 in 1990, and 107 in 1991 if Congress faiis to do anything.

I hope Congress doesn't fail to do anything, but if those figures are a more accurate reflection of what we should expect, it seems to me it puts continued pressure on the Congress but makes the achievement of goals that we have established under Gramm-Rudman more obtainable, certainly within our reach or within our grasp.

As I figure it out, we are talking about $38 billion—we are within $38 billion of a $144 billion deficit cap under OMB assumptions and $34 billion under CBO assumptions. That amounts to something like less than 4 percent of the total Federal outlays.

It seems to me if those figures hold up Congress ought to be able to do the job.

I join the chairman in hoping that your figures are accurate. I join the chairman in hoping that the figures of the Congress are accurate.

Obviously, we have had trouble in the past of making projections, some would say depending on economists. I am not sure economists' track record is any worse than Members of Congress. I am not sure we have done a better job.

These figures are important for us. Sequestering is an extremely important factor. A lot of people are fearful of it.

Some people suggested Congress would finally get serious and attempt to balance the budget in the worst possible way. Some people think we have succeeded in attempting to balance it in the worst possible way.

I just hope that with your help and our help and a good faith commitment on the part of all of us we can in fact move toward what I think everyone agrees we ought to move toward, a little better fiscal restraint on the part of the Federal Government.

And I certainly look forward to your testimony and your answers to questions today.

Representative OBEY. Congressman Wylie.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Thank you, Mr. Chairman.

I want to join you and others in welcoming with warmness the first witness at our hearing on the 1986 Economic Report of the President.

Two days ago President Reagan presented his goals in his State of the Union Message, and I think it was one of the finest State of the Union Messages that I have ever heard, and I think we have reason to be very optimistic, given the upbeat tone of it.

Particularly, the last year is one to be proud of. As the President pointed out, the economy is continuing to grow, more jobs were created, interest rates fell, and the rate of inflation remained at an acceptable level, and while we have a long way to go in restoring the farm sector to prosperity and making our industries more competitive, we should take pride in having experienced a prosperous economy which remains strong around the world.

I was particularly pleased that the Federal Reserve has coordinated some of its efforts with yours, and even though we have had to finance a budget of truly enormous size, I think that under the leadership of Chairman Volcker he has managed to avoid some of the dangers of high interest rates given that high budget deficit, and I think that the deficit does remain our No. 1 problem, as Congressman Lungren pointed out.

I am looking forward to some substantial progress there and hope that Gramm-Rudman can provide the discipline to help us get to the progress that we need to make.

Thank you, Mr. Chairman and, Chairman Sprinkel, I look forward to your testimony.

Thank you very much.

Representative OBEY. Thank you. Mr. Sprinkel, why don't you just summarize your—oh, I am sorry, Parren, I didn't see you come in.

Representative MITCHELL. Well, I was late getting in, and I apologize for that.

Good to see you, Mr. Sprinkel.

Mr. SPRINKEL. And you, sir.

OPENING STATEMENT OF REPRESENTATIVE MITCHELL

Representative MITCHELL. I particularly wanted to be here because being the kind of Hamlet character that I am, I am not always caught up in this ecstatic mood about the state of the economy and all that we are doing, and it was just a very propitious circumstance that we had a report recently, a report requested by myself and Congressman Bedell, requested of the Congressional Office of Technology Assessment.

We requested that report because we were both concerned about what appeared to be the permanent unemployment that has been stuck at a very high level for more than a year.

The report discloses that the problem of displaced workers continues to add to the high unemployment rate despite all the glowing statements about new jobs being created.

By way of illustration, the report discloses only 3.1 million, or about 60 percent, of displaced workers were reemployed.

It also discloses that some 1.3 million of displaced workers were still unemployed, and of that about 700,000 of displaced workers had dropped out of the labor market.

If you examine the statistics a little more carefully, it reveals that three groups bear the burden of this. Women had only a 53

percent rate of reemployment following displacement. Blacks, of course, had a 42-percent rate, and those over 55 had only about a 33-percent rate.

So I wanted just to get this into the record to make it clear that while there are these very glowing, ecstatic reports about all that has been accomplished, this Nation faces a very serious problem because the cost of unemployment remains at about $23 billion for every 1 percent, and we are still above the 7-percent range or close to it.

Obviously, this has an impact on our industrial business.

The study further reveals a net loss in jobs in 1985, 200,000 jobs in mining and manufacturing, that more businesses had gone into bankruptcy than at any time since the Great Depression, and a 37-percent decline in the rate of net job generation.

I think we have to have these harsh realities laid alongside the ecstasy that was disclosed in the President's state of the Union message.

Thank you very much, Mr. Chairman.

Representative OBEY. Senator, do you have any brief remarks before we allow the witness to begin his testimony? [Laughter.]

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Well, Mr. Chairman, you know, coming from that other body, that brief remarks are something that generally we are not used to.

I am pleased to have the opportunity to be here with you, Mr. Chairman, and I am very much interested in the report, and I would be particularly interested in what this would view as the future, and I know that is fairly difficult, giving budgets that are put forth.

But there is something, Mr. Chairman, that concerns this Senator. It seems to me that there is a great doubt out there with respect to the tax legislation that has been passed by the House and is now over in the Senate, and businesses are confounded.

I had my county treasurer call me today and say that he has held up the sale of all bonds, he can't sell bonds because of some of the provisions in the tax law with respect to 30 days, that they must use those funds within 30 days, and it seems to me that with the uncertainty as to what time the implementation for the tax law will be we are making—we have all the ingredients for a very real recession.

And I am wondering if in his report we might hear Mr. Sprinkel comment. I think that we should get both Houses together, regardless of what the final version of the bill is, if there is one, that the effective date will be something in the future and not something in the past.

I am wondering if you would share your concerns for that chilling effect on the business climate that is taking place throughout America today.

So, Mr. Chairman, that would be my question.

Representative OBEY. Well, I assume then that you've already got a question on what you think on your testimony before the committee. [Laughter.]

At this point, I will place in the hearing record Senator Abdnor's written opening statement, at his request, who could not be present for today's hearing.

[The written opening statement of Senator Abdnor follows:]

WRITTEN OPENING STATEMENT OF SENATOR ABDNOR

MR. CHAIRMAN, WELCOME TO OUR COMMITTEE'S ANNUAL ECONOMIC OUTLOOK HEARING. YOU ARE THE LEADOFF WITNESS IN A PARADE OF INFLUENTIAL AND IMPORTANT WASHINGTON POLICYMAKERS. PEOPLE THROUGHOUT THE NATION WILL BE LISTENING INTENTLY TO WHAT YOU SAY. BUT WHAT CONCERNS ME IS WHAT I AM NOT GOING TO HEAR FROM YOU TODAY, OR FROM ANY OTHER OF OUR WITNESSES EITHER.

IN ALL THE GOOD NEWS AND HAPPY TALK ABOUT THE NATIONAL ECONOMY, IT'S EASY FOR THE ADMINISTRATION TO IGNORE PROBLEMS IN THE HEARTLAND, OR PERHAPS EVEN EASIER TO DENY THAT PROBLEMS EXIST. WHEN IS WASHINGTON GOING TO WAKE UP TO THE HARD, CRUEL TRUTH ABOUT THE CONDITION OF THE FARM AND RURAL ECONOMY?

THE DEPARTMENT OF AGRICULTURE FORECASTS A DECLINE IN EXPORTS THIS YEAR. EXPOTS ARE EXPECTED TO FALL TO $29 BILLION, COMPARED TO $31.2 BILLION LAST YEAR AND $38 BILLION IN 1984. THEY ALSO FORECAST THE SIXTH CONSECUTIVE YEAR OF DECLINING U.S. AGRICULTURAL EXPORTS MEASURED BY VOLUME. EXPORTS HAVE FALLEN 26 PERCENT BY VOLUME AND 34 PERCENT BY VALUE SINCE 1980-81.

MOST DISTURING IN THIS BAD TREND IS THIS:- ONE-THIRD OF THIS LOSS OF FARM SALES CAN BE TRACED TO BUT TWO CUSTOMERS -- OUR GOOD FRIENDS -- THE EUROPEAN ECONOMIC COMMUNITY AND JAPAN. ONE IS TEMPTED TO CHASTISE THESE CUSTOMERS UNTIL HE READS THAT EUROPEANS HAVE DECIDED TO FURTHER RESTRICT U.S. SHIPMENTS OF FERTILIZERS, BEEF FAT AND PAPER PRODUCTS IN RESPONSE TO A U.S. ACTION TO LIMIT IMPORTS OF EUROPEAN SEMI-FINISHED STEEL. NOW, WHO SHOULD BE CHASTISED?

SHOULD THIS ACTION BE INTERPRETED AS A CONSCIOUS DECISION BY THIS ADMINISTRATION TO AID ONE SECTOR OF THE ECONOMY AT THE COST OF ANOTHER? AMERICAN FARMERS AND RANCHERS HAVE BEEN THE VICTIMS OF THIS KIND OF ECONOMIC DISCRIMINATION FOR DECADES. WHILE A LOWER VALUED DOLLAR IS NECESSARY FOR A REVIVAL OF AGRICULTURAL EXPORTS, IT IS NOT A SOLUTION BY ITSELF. LET'S BE HONEST AND FACE THE FACTS: AMERICAN AGRICULTURE INTENTIONALLY HAS BEEN BLED DRY BY FEDERAL POLICIES DANCING TO THE TUNE OF URBAN, CONSUMER, AND STATE DEPARTMENT PRIORITIES.

FARM PROBLEMS ARE JUST THE HALF OF MY GRIPE. THE FAILURE OF THE ADMINISTRATION AND THE URBAN-DOMINATED CONGRESS TO ADDRESS THE PROBLEMS OF THE ENTIRE RURAL ECONOMY IS A NATIONAL DISGRACE AS FAR AS I AM CONCERNED.

THIRTY-NINE MONTHS OF ECONOMIC EXPANSION AND HEARTLAND AMERICA HAS YET TO SEE A RECOVERY. LET ME TELL YOU A TALE OF TWO AMERICAS, MR. CHAIRMAN:

* SIXTEEN STATES HAVE A MAJORITY OF THE POPULATION RESIDING IN NONMETROPOLITAN AREAS. THESE STATES HAVE 12 PERCENT OF THE TOTAL U.S. POPULATION, YET EARN ONLY 9 PERCENT OF TOTAL PERSONAL INCOME.

* PERSONAL INCOME GROWTH IN 15 OF THE 16 MOST RURAL STATES IN THE U.S. WAS BELOW THE NATIONAL AVERAGE IN 1985.

* JOB CREATION WAS DISMAL IN THESE RURAL STATES. OF THE 2.1 MILLION NEW JOBS IN THE 12 MONTHS ENDING IN JUNE OF LAST YEAR, ONLY 121,000 WERE IN RURAL STATES. LESS THAN ONE OUT OF 20 NEW JOBS WERE CREATED IN THESE RURAL STATES.

* OF THE TEN STATES WITH THE WORST BUSINESS FORMATION RATES AS OF SEPTEMBER 1985, NINE WERE RURAL STATES.

* THE THREE STATES WITH THE WORST BANKRUPTCY LAST YEAR WERE RURAL STATES. THREE-FOURTHS OF THESE RURAL STATES EXPERIENCED WORSENING BANKRUPTCY PICTURES IN 1985.

NOW, MR. CHAIRMAN, HEAP THE PROBLEMS OF A SIX-YEAR AGRICULTURAL RECESSION ON TOP OF THESE FIGURES AND TELL ME THAT RURAL AMERICA HAS SOMETHING TO CHEER ABOUT. IT IS MY SINCERE HOPE THAT THIS EXPOSURE TO THE HARSH REALITIES OF THE RURAL ECONOMY IS A SOURCE OF ENLIGHTENMENT FOR YOU, AND NOT JUST A RUDE AWAKENING. I URGE YOU TO TAKE MY MESSAGE TO THE ADMINISTRATION.

BELIEVE ME, OUR NATION CANNOT AFFORD TO LET THIS RURAL CRISIS BECOME A CATASTROPHE. LEST WE FORGET, MAY I REMIND YOU OF THE IMMORTAL WORDS OF WILLIAM JENNINGS BRYAN:

> "BURN DOWN YOUR CITIES AND LEAVE OUR FARMS,
> AND YOUR CITIES WILL SPRING UP AGAIN AS IF BY MAGIC,
> BUT DESTROY OUR FARMS AND GRASS WILL GROW IN
> THE STREETS OF EVERY CITY."

Representative OBEY. Mr. Sprinkel, please proceed.

STATEMENT OF HON. BERYL W. SPRINKEL, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY THOMAS G. MOORE, MEMBER

Mr. SPRINKEL. Chairman Obey, distinguished members of this committee, it is indeed a pleasure to appear before you today to discuss the 1986 Economic Report of the President, and also the Annual Report of the Council of Economic Advisers. I'm especially pleased to be here because of the longstanding, close relationship between the CEA and your committee, which I think has been a very useful one over its history and I'm sure, in the future, will remain so.

Representative OBEY. We do, too. I would just—excuse me for interrupting. I don't know if I indicated it earlier, I don't remember, but please feel free to summarize. I think we've read your prepared statement. Please feel free to summarize it and say whatever you want.

Mr. SPRINKEL. I plan to submit the prepared statement and try to make some brief comments on it. I do want to introduce my colleague who is with me today, Mr. Thomas G. Moore, who is a member of the Council of Economic Advisers. Some of you know him. He specializes in the microeconomic issues and has been very helpful to me in developing this report.

And also, I must and want to thank my staff, who worked for so many long hours over the past 3 months. I will summarize briefly and then we will try to answer your questions.

It's true, Congressman Mitchell, that we have focused on some positive economic developments in this report, but it's also true that we do attempt to address many of the important problem issues that remain. In addressing these remaining problems, it's critical that we do so with policies that are also consistent with protecting and extending the significant positive economic progress that's been achieved over the past 3 years. If you look at our report, which I'm sure you will do, I think there are two underlying themes that permeate the chapters.

One is a continuous emphasis on the cost to the Nation of experiencing cycles of inflation followed by disinflation. It's detrimental to economic growth, creates problems of unemployment, creates problems in agriculture, creates problems in our financial institutions, and among the debtors who make borrowing decisions at a time when they expect high rates of inflation to persist over an extended period. We argue that high and variable inflation distorts economic incentives, distorts price signals, encourages nonproductive activities, and clearly impedes stable economic performance.

The increase in inflation brought on enormous increases in interest rates. Real growth declined. Unemployment rose. And once the inflation rate rises, it is very painful and costly to get it back down. We have borne these costs on four separate occasions in the past 20 years—1969–70, 1974–75, 1979–80, and again in 1981–82. Each episode, unfortunately, has been associated with a recession, which brings on a lot of pain and misery around the country. Unfortunately, expectation of inflation lingers even after the inflation rate

falls, so that interest rates stay high. It takes a long time for them to fall. The debt problems in agriculture, energy sectors, less developed countries, and the associated impact on our financial system are indeed a heritage of this disinflation process.

The second major theme relates to the contribution to economic efficiency and welfare that can be achieved with a market system that is flexible and allows markets to provide the right signals to produce, to consume, and to conserve. A flexible market system is the best mechanism for achieving high employment of resources and for directing those resources into their most productive use. We think that government should and must avoid distorting or blunting these production incentives by implementing high or differential marginal tax rates, or by extensive and distorting government regulation.

Let me describe very briefly the specific chapters of the report. The first chapter is, I think, conventional. It concentrates on broad macroissues. It's labeled "The Inflation, Disinflation, and State of the Macroeconomy." This chapter reviews this expansion in relation to prior postwar recoveries. It concludes that this expansion looks quite good in most respects. The chapter also compares this recovery with what's happening in other developed parts of the world and demonstrates that our performance has generally been superior. This chapter also presents the administration's forecasts. I'll return to the forecast in a few moments.

Chapter 2 discusses the United States and economic development. I think it's fair to say, incidentally, that this particular report places more emphasis on the United States in relation to the rest of the world than most of its predecessors, perhaps because it's becoming increasingly clear that we can't look upon the United States alone. Rather, we have to consider the United States with respect to other developed and developing countries. This particular chapter focuses very heavily on the relationships between the United States and developing countries.

The open system of world trade has promoted rapid growth in developing countries. Recently, the problems that have developed in some of those countries have become quite obvious. We, for the first time, explore a rather sizable literature to try to summarize the kinds of policies that have contributed to growth. All of us want to grow—the poor countries want to grow, the rich countries want to grow.

There is a lot of evidence that has accumulated, studies that have been conducted pertaining to this issue. We touch on several of the development policies that have actually worked in that chapter, policies such as allowing markets to function properly; the importance of achieving and maintaining fiscal discipline; the importance of restraining inflation with monetary discipline; the importance of keeping a properly valued exchange rate; the importance of pursuing an open policy with respect to international trade; and the importance of limiting distortions of domestic product and factor markets. Finally, we emphasize the importance of maintaining political stability; because, frequently, political instability prevents achievement of economic growth.

We also have a section in that chapter dealing with what the developed world can do to improve the performance and the working

out of the debt problems in developing countries. The chapter indicates that we must maintain strong growth, continue the flow of credit to countries pursuing appropriate progrowth policies and do our best to support an open system of international trade.

Chapter 3 deals with protectionism in the United States and the world's trading system. We argue here that protectionism does not save jobs, it does not reduce the trade deficit, and it does not prevent deindustrialization—which, incidentally, is not occurring. The chapter reviews the administration's actions in areas such as footwear, steel, semiconductors, agricultural exports. It discusses the administration's policy with respect to promoting free and fair trade in the 1980's and into the next decade.

Chapter 4 concentrates on another problem area. That is agriculture. Specifically, the chapter deals with income transfers to agriculture. It tries to analyze the cost and benefits of Federal programs designed to support farm income. It is shown that efforts to transfer income by artificially raising prices have led to important distortions and inefficiencies. We believe there are more efficient ways to implement income transfer that will not distort the decisionmaking process. We review the recently passed Food Security Act of 1985 and the advantages of that act, especially those moving toward lower loan rates. We do point out that problems remain. The President has indicated that he wants some changes in the dairy program, in the export subsidy area, and in the sugar program.

Chapter 5 deals with reforming regulations and strengthening market incentives. It reviews what I think is the great success of deregulation, some of which began in previous administrations. We have carried forward deregulation of airlines, trucking, and railroads, and indicate in the report the potential benefits from further deregulation in transportation, natural gas, and fuel economy standards. Again, we emphasize the virtue of a market-based system of regulation where deregulation should be continued. And we give several examples where that would be useful. We also discuss in this chapter the gains to be achieved from privatization of certain government assets and activities; the selling of some government assets are proposed. In addition, we discuss the possibility of eliminating government monopolies in certain areas such as the postal system.

Chapter 6 again focuses on problems, specifically, the Federal role in credit markets. Incidentally, we argue in the agriculture chapter that the inflation-disinflation process, along with the types of agricultural programs that we've had in the past, have importantly contributed to problems in agriculture. The same point can be made is applicable to credit market problems in general.

We must prevent a reemergence of high notes of inflation because in an inflationary environment credit decisions are frequently made which come home to roost after the disinflationary process begins. We believe that excessive financial regulation has contributed to problems in financial institutions. We discuss various means of removing distortions from government policies that in some cases encourage excessive risk taking. We also discuss how to get better control over costs of government loan and loan guaran-

tee programs as well as to correct serious actual and perspective problems with the Government's pension insurance system.

Chapter 7, the final chapter, is entitled "The Economic Effects of Immigration." It examines the economic consequences of international migration on the United States. Recent immigration, including illegal immigration, is low in comparison to earlier periods in our history. We believe immigrants are readily absorbed into the labor market, providing positive effects on aggregate income and perhaps a net fiscal benefit, although in certain communities, that clearly is not true. The chapter does not address the problems of law enforcement and we make very clear both at the beginning and near the end of that chapter that it should in no way be interpreted as condoning illegal immigration. A great nation certainly has the right to determine who comes into a nation and who has the right to stay.

Let me briefly turn now, if I may, to the current expansion. We have made a lot of progress. We've broken the high rates of inflation experienced in the late 1970's. Interest rates have come down. Unemployment has come down. It's not unusual for inflation to moderate early in a recovery, but we have now had low inflation for 3 years, moving into the fourth. Inflation over the past 3 years has been the lowest in 15 years. The President has made it very clear to me and others that we have not firmly established his objective of price stability. I can remember, and I guess that's because I'm old, when 3-percent inflation was considered a disaster. Three to four percent brought price controls in some periods in our history, so we shouldn't be too complacent about the achievements we've made. Interest rates have come down 5 to 10 percentage points. And, again, if we can get inflation down further, we can get interest rates down more.

Employment growth has been unusually strong in this expansion. Total employment has grown in excess of 9 million. The unemployment rate has come down about 3.8 percentage points, but it still remains uncomfortably high, from my point of view.

Another important characteristic of this expansion has been the unusual strength in business fixed investment, which not only has turned out to be a major contributor to our expansion, but also bodes well for future productivity improvement. We explain that this strong capital investment trend, despite high real-interest rates, is clearly due to the incentives created by the President's tax initiatives. This created prospects for high rates of return.

Despite these impressive gains, problems remain. Unemployment is one problem that I've already mentioned. The fact that unemployment was at a very high level before the recession began in 1981–82 should be noted. We had very sluggish real growth in the seventies, and unemployment trended up during this period. It is taking a long time to get unemployment down to satisfactory levels.

Turning for a moment to the outlook for 1987–91, that is, the longer term projections, it's important to note that——

Representative LUNGREN. You realize we're not leaving because of anything you're saying——

Mr. SPRINKEL. I wondered. [Laughter.]

Representative LUNGREN. We have a vote on. What we tried to do was rotate it so some members could get over to vote and the rest of us would get over, but the others haven't come back. We're going to miss it. But, the Senator, I understand, will stay. [Laughter.]

We will come back as quick as we possibly can.

Mr. SPRINKEL. OK. I will get to the end as quickly as I can. Let me say that the 1987–91 numbers which are in the report should not be interpreted as forecasts, as are the 1986 numbers. They're projections based on longer term trends. They contain some important assumptions; namely, the President's objectives on tax reform; his objectives on Gramm-Rudman-Hollings—that is, meeting those targets without a tax increase; and the objectives of gradually slowing money growth—so that we can bring that inflation rate down to 2 percent, the inflation rate projected for 1991. These assumptions have to be taken as given. If these assumptions are not met, obviously, those longer term trends will not develop as projected. We think we have the potential to achieve them and if we can implement the correct policies and get cooperation from the Congress, the odds of achieving them are good. But, there is no one that has the power to accurately forecast 3, 4, 5 years into the future with a high degree of certainty. But it's a legal requirement that I must make these projections, and I've done my best.

I agree with some earlier observations, that there are question marks out there. The 1986 portion of the projections—that is for the months over this year—we do look upon as a forecast. And our accuracy should be judged at the end of the year. We are very confident that we will achieve the 4 percent real growth, fourth quarter to fourth quarter, during the year 1986. This confidence essentially relates to two types of evidence.

First, the early foreshadowing trends that tend to move ahead, either of a recovery or a renewal of an expansion, are almost all favorable. For example, the leading indicators have advanced in 11 out of the last 12 months. The stock market, which is one of them, hit a new high this week. Inflation is still quite restrained, and inventories appear quite low in relation to sales. Most importantly, sales and orders have been moving up, which means that the drag on economic performance which was evident this past year is behind us. Additionally, the money supply has grown sufficiently to fuel a substantial reacceleration of real economic activity this year.

Furthermore, recent evidence is fully consistent with the argument that renewed expansion is underway. Trends in unemployment, for example, have been favorable. Recent trends in industrial production have also been favorable. Almost all of the evidence indicates that we are expanding at a rapid rate. When we made our forecast, a month or two ago, we were not the highest published economic forecast, but we were well above the average. The average is now moving up. We will be in the middle before very long. And there are still many economists in whom I have considerable confidence, because I've watched their performance over a long period of time, whose projections are well above ours.

So, in conclusion, we think that the prospects for renewed economic growth in 1986 are very good. We think the potential for continuing expansion over the balance of this decade and into the

early nineties is present, and such a continuing expansion depends on the adoption of proper policies. We do not believe that business expansions die of old age. They die of inappropriate economic policies. With your cooperation and with the Federal Reserve's cooperation, we will do our best to avoid those inappropriate policies.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Sprinkel follows:]

PREPARED STATEMENT OF HON. BERYL W. SPRINKEL

Chairman Obey, Senator Abdnor, distinguished Members of the Committee, it is a pleasure to appear before you today to present the 1986 Economic Report of the President and the Annual Report of the Council of Economic Advisers. Accompanying me today is Thomas G. Moore, Member of the Council of Economic Advisers, who specializes in micro-economic issues. This morning I would like to thank my staff who worked many long hours on this Report. I will summarize briefly the content of the Report and also discuss the Administration's economic outlook for 1986 and for the longer term period through 1991. Then Dr. Moore and I will be happy to answer your questions about the Report or other economic issues of interest to the Committee.

In preparing the Report we have not only focused on the positive economic developments so far in this expansion, but

have also discussed the important economic problems that remain. In addressing these remaining problems and imbalances, it is critical that we do so with policies that are also consistent with protecting and extending the significant, positive economic progress that has been achieved over the past three years.

Two broad themes dominate the Report. The first is that the cycles of inflation and disinflation experienced over the past two decades are detrimental to economic growth and stability. A high and variable inflation rate distorts economic incentives and price signals, encourages non-productive activity and is thereby likely to impede sound and stable economic performance. The rise in inflation in the 1970s was reflected in a secular rise in interest rates, while real growth declined on average and the unemployment rate rose. Once inflation is allowed to rise, policies necessary to reduce it are costly as well. These costs were borne by the American public on four separate occasions in the past 20 years; in 1969-70, 1974-75, briefly in 1979-80 and again in 1981-82. In each of these episodes, disinflationary monetary policy was associated with a recession and, in two cases, these recessions were severe and prolonged.

In addition, once expectations of high inflation are incorporated into economic behavior and contracts, the adjustment to inflation is likely to linger after the actual inflation rate is reduced. The debt problems present today in the agriculture and energy sectors, as well as the debt problems of many less developed countries, are a heritage of the inflation-disinflation process. During the late 1970s, credit was frequently extended on the presumption that land and commodity prices would continue to rise rapidly. When the actual inflation rate fell below this expectation, real debt burdens rose as assets were revalued, leading to many problems for both debtors and creditors.

The second basic theme of the Report is that economic efficiency and welfare are maximized if the private market system is allowed to function as freely as possible. A market system in which prices are free to adjust is the best mechanism to ensure full employment of resources and to direct resources to their most productive uses. In addition, a flexible price system implies an adaptable macroeconomy that can adjust to external or unforeseen shocks with a minimum of economic disruption. To enhance the functioning of the market system, the government should avoid distorting or blunting productive incentives by high or differential marginal tax rates and by excessive government regulations.

The Report of the Council of Economic Advisers

Chapter 1 of the Report entitled, "Inflation, Disinflation and the State of the Macroeconomy," introduces these basic themes which are then applied to specific areas of interest in subsequent chapters. Chapter 1 also reviews the economic expansion to date and discusses in more detail some of the outstanding features of this expansion compared to other postwar expansions. Finally, it presents the Administration's forecasts for 1986 and its longer term projections for the 1987-91 period.

Chapter 2, "The United States and Economic Development," examines the economic performance and problems of developing countries and their relationship to the United States. Under the open system of world trade and investment established after World War II, developing countries have generally enjoyed strong economic growth. Recently, however, many developing countries, especially those with large external debts, have suffered severe economic difficulties. To restore prosperity and confidence, these countries should pursue policies that experience indicates are conducive to rapid and sustainable economic growth: allow markets to function; maintain reasonable fiscal discipline; restrain inflation; keep an appropriately valued exchange rate; pursue an open policy

toward international trade; limit distortions of domestic product and factor markets; and maintain political and economic stability. To assist developing countries in restoring prosperity and credit-worthiness, the United States and other industrial countries need to maintain strong growth of their own economies, improve the flow of credit to developing countries pursuing appropriate pro-growth policies, and support the open system of international trade and investment.

Chapter 3, "Protectionism and the U.S. in the World Trading System," examines key issues of U.S. international trade policy. It exposes the fallacies in the common arguments that protectionism will save jobs, reduce the trade deficit, or prevent deindustrialization, which has not and is not occurring. It analyzes recent Administration actions in the areas of footwear, steel, semi-conductors, and agricultural exports, in the context of the Administration's general policy to promote free and fair trade by encouraging other countries to open their markets to our goods, rather than closing our markets to their goods.

Chapter 4, "Income Transfers to Agriculture," analyzes the costs and benefits of Federal programs to support farm incomes. Efforts to transfer income to agriculture by artificially raising prices received by farmers generate

important economic distortions and inefficiencies. More efficient, less costly mechanisms are available to achieve this objective. The Food Security Act of 1985 moves toward this more desirable mechanism, especially in its programmed reductions in support prices, but its weaknesses in the areas of dairy programs, export incentives, and sugar need to be corrected.

Chapter 5, "Reforming Regulation: Strengthening Market Incentives," reviews largely successful efforts at deregulation of airlines, trucking and railroads, and indicates potential benefits from further deregulation in the areas of transportation, natural gas, and fuel economy standards. It also discusses the virtues of using more market-based systems of regulation in essential areas of government involvement, especially environmental quality. Finally, this chapter examines how "privatization" of some government activities,that is, selling some government assets (such as the Bonneville Power Marketing Authority) and eliminating some government monopolies (such as the postal monopoly) could enhance economic efficiency.

Chapter 6, "The Federal Role in Credit Markets," analyzes the contributions of the inflation-disinflation process and of excessive and inappropriate regulation to the problems recently

experienced by many financial institutions, especially the thrifts and agricultural lenders. To avoid repetition of these problems, we must prevent a new surge of inflation, continue with financial deregulation such as further programs towards interstate banking, and correct remaining distortions arising from government policies that encourage excessive risk taking by some financial institutions. In addition, it would be desireable to obtain better control over the costs of government loan and loan guarantee programs, and to correct the serious actual and prospective problems with the government's pension insurance system.

Chapter 7, "The Economic Effects of Immigration," examines the economic consequences for the United States of international migration. Recent immigration, including illegal immigration, has been relatively low in comparison with earlier history. New immigrants have been readily absorbed into the labor force, have had a positive effect on aggregate income, and may provide a net fiscal benefit for the Nation. The chapter does not address social and political concerns relevant to immigration policy, nor does it address law enforcement. It makes clear that the United States cannot condone illegal immigration.

Characteristics of the Current Expansion

It appears that the pattern of persistently higher inflation, interest rates and unemployment that characterized the 1960s and 1970s has been broken in the current expansion. While it is not unusual for inflation to moderate early in an expansion, on average in other postwar expansions a substantial reacceleration of inflation has been evident by the third year. In contrast, the four-quarter change in the GNP deflator was lower in the fourth quarter of 1985 than at any time in this expansion. In addition, inflation during the past 3 years has been lower than in any 3-year period for more than 15 years.

Interest rate movements in 1985 indicate that their secular rise may also have been broken in this expansion. At year-end 1985, interest rates were below the levels that existed when the expansion began, and 5 to 10 percentage points below their previous cyclical peaks. After more than two decades of successively higher peaks and troughs in interest rate cycles, during 1985 the monthly levels of most short- and long-term interest rates fell below the cyclical lows reached in mid-1980.

Employment growth in this expansion has been exceptionally strong as total employment has risen by over 9 million with almost 2 million of this increase occurring in 1985. The 3.8

percentage point decline in the unemployment rate is the largest drop in the unemployment rate in a three-year period since 1949. This record of employment growth is exceptional when compared either to historical experience or to employment growth in other industrial countries.

Strong business investment has been a major contributor to this expansion. Motivated in part by the Administration's tax changes, real nonresidential investment has contributed nearly twice as much to real GNP growth in this expansion as in previous postwar expansions. For the second consecutive year, real gross business fixed investment in 1985 reached a postwar high as a share of real GNP.

Despite these continued impressive gains during the expansion, important problems remain. Although employment growth has been very strong, the unemployment rate remains high by historical standards. This reflects, among other things, the fact that the unemployment rate was at a postwar high when this expansion began -- the accumulated result of sluggish real growth in the 1970s and back-to-back recessions in 1980 and 1981-82. Productivity growth in this expansion has been well below the postwar trend. Productivity performance was particularly weak in 1985, but this may be a short-term reflection of changes in output growth in the face of continued strong employment growth.

The strong dollar -- itself a manifestation of a strong growth in the U.S. -- has contributed to the problems of U.S. agriculture and some manufacturing industries. Even after three years of solid real growth and substantial gains in employment, some industries exposed to increased international competition have had trouble adjusting to this new environment. Finally, we have not achieved price stability. Inflation, now in abeyance, could be reignited by excessive monetary growth.

The Outlook for 1986-91

If the expansion continues through 1986 as expected, it will exceed the 45-month average length of all postwar expansions. The evidence, however, does not indicate that the probability of a recession rises as an expansion proceeds. Instead, it appears that expansions end as a result of an accumulation of policy errors and unexpected shocks, neither of which is subject to any regular pattern.

At present, there is no evidence of the economic conditions and imbalances that frequently precede economic slowdowns. Indeed, the indicators point to an acceleration of real growth from the 2.5 percent pace of 1985. Specifically, the leading economic indicators have risen 11 of the last 12

months, including a 0.9 percent rise in December. Money growth during the past year has been ample to accommodate increased economic growth. A substantial slowdown in inventory accumulation during 1985 has left inventories at very low levels. Consequently, I expect continued growth in final sales to generate increased production. Most interest rates are at their lowest levels in more than six years and inflation remains low. Despite the substantial gains in employment, considerable slack persists in labor markets and excess capacity remains in most industries. The rapid growth of business investment during this expansion bodes well for future output and productivity growth.

Chapter 1 of the Report presents the Administration's forecasts for 1986 and its longer term projections for 1987-91. The projections for 1986 should be considered forecasts that represent our best estimate of economic performance, given assumed policies and current conditions. The projections for 1987-91 should be interpreted as expected longer term trends, rather than as point forecasts for individual years.

Both the forecasts for 1986 and the longer term projections are contingent on several critical policy assumptions.

The long-term inflation and real growth projections are conditional on a deceleration of money growth that is consistent with achieving price stability over the long run. Near-term real growth forecasts are contingent on the assumption that the deceleration of money growth is gradual enough to avoid any policy-related disruption to the real economy. The long-term projections assume that the Gramm-Rudman-Hollings deficit reduction targets are met by reducing the growth of government spending, not by raising taxes. Reducing government spending frees resources that can be more productively employed in the private sector, while raising taxes distorts and diminishes incentives for economic growth. Finally, it is assumed that a tax reform bill is enacted that is similar to the President's Tax Proposals for Fairness, Growth, and Simplicity. Lower marginal tax rates for individuals and businesses and more uniform tax rates for different forms of investment enhance incentives for efficiency and growth.

For 1986, the Administration forecasts that real GNP will rise 4.0 percent on a fourth quarter to fourth quarter basis between 1985 and 1986, and by 3.4 percent on a yearly average basis. Employment is projected to rise by 1.7 million, a 1.5 percent gain over 1985, and productivity (output per hour) is expected to rise 1.8 percent. The unemployment rate projection shows only a modest decline, to 6.7 percent by the fourth quarter of 1986, but we may well achieve better results

in this important area. Housing starts are expected to rise to 1.9 million units by the fourth quarter. Relatively high money growth and the depreciation of the dollar during 1985 are expected to contribute to moderately higher inflation in 1986: on a fourth quarter to fourth quarter basis, the GNP deflator is expected to rise 3.8 percent, versus 3.2 percent on that basis for 1985. Lower oil prices will tend to moderate measured inflation and stimulate real growth.

The Administration's longer term economic projections for 1987 through 1991 are summarized in the attached table. For real GNP, the projection is a growth rate of 4.0 percent in 1986 and 1987, tapering off to 3.5 percent in 1991, for an average annual growth rate of 3.8 percent over the six-year projection horizon. As illustrated in the attached chart, this projection does not imply extraordinary or unprecedented real growth. Indeed, the projected path for real GNP gradually approaches, but remains below, the postwar trend path of real GNP fit through the cyclical peaks of 1948 and 1981.

The inflation rate, as measured by the GNP deflator, is projected to rise modestly above its 1985 level in 1986 and 1987, and then decline gradually (under the effect of a gradual reduction in money growth rates) to reach 2.0 percent in 1991. The unemployment rate is projected to decline steadily to

60-987 O - 86 - 2

5.5 percent by 1991. Lower actual inflation and greater confidence of lower future inflation are anticipated to contribute to lower interest rates, with Treasury bill rates falling to 4.0 percent and 10-year government bond rates falling to 4.5 percent by 1991.

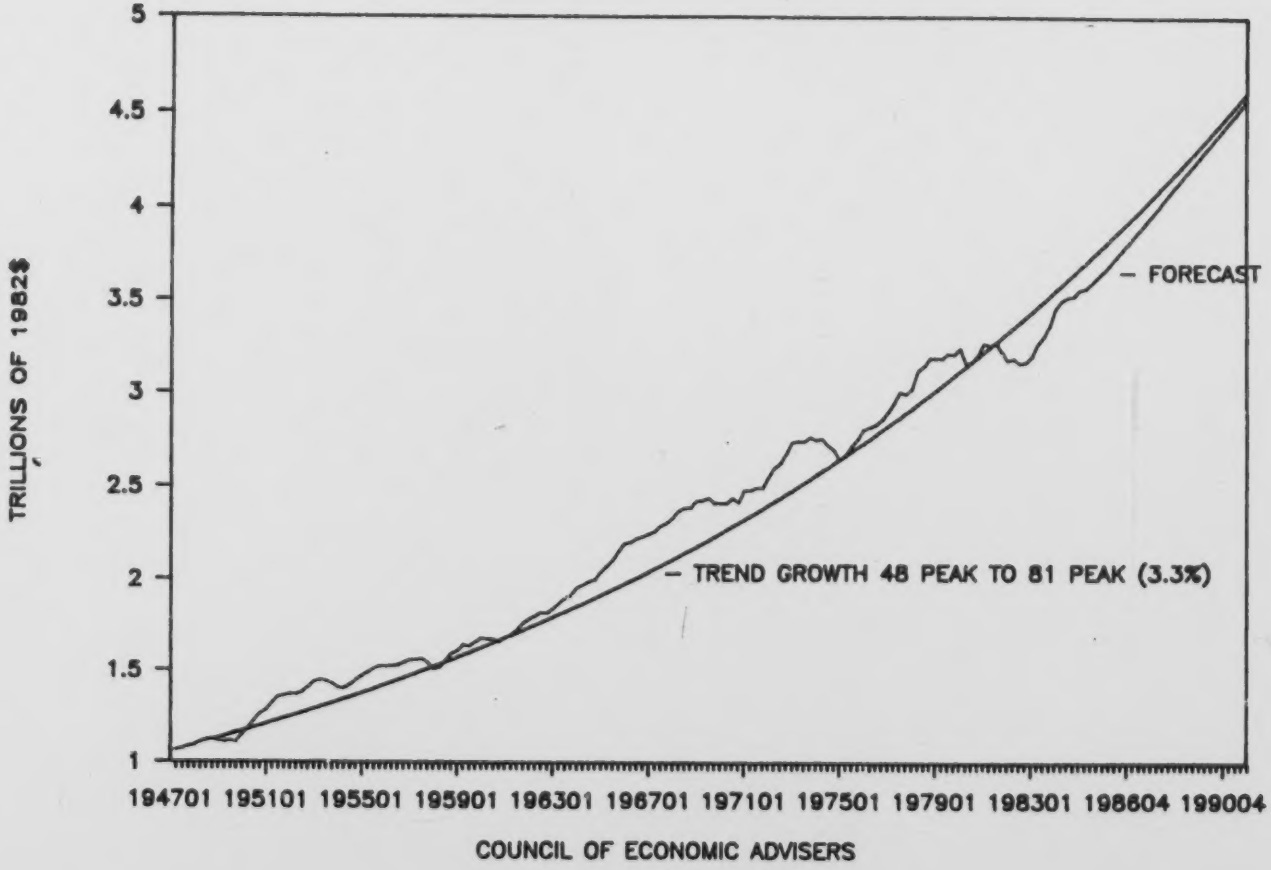
These long-term projections of sustained growth, declining inflation and interest rates, and falling unemployment are premised on microeconomic policies that maintain incentives for economic efficiency and on stable and predictable macroeconomic policies that are conducive to economic growth and that will lead to the long-term goal of price stability. The policies of this Administration have provided an environment within which strong economic growth has been combined with declining inflation, large employment gains and a declining unemployment rate. A continued commitment to this course is the key to the realization of our projections for 1986 to 1991.

oOo

ECONOMIC PROJECTIONS FOR 1986-91

	(Percent Change)				(Percent)			
	Real GNP		GNP Deflator		Total Unemployment Rate		91-Day Treasury Bill Rate	
Calendar Year	Year/Year	IVQ/IVQ	Year/Year	IVQ/IVQ	Average	IVQ	Average	IVQ
1986	3.4	4.0	3.5	3.8	6.7	6.7	7.3	7.2
1987	4.0	4.0	4.2	4.1	6.5	6.5	6.5	6.1
1988	4.0	4.0	3.7	3.6	6.3	6.2	5.6	5.3
1989	3.9	3.7	3.3	3.2	6.1	6.0	4.8	4.5
1990	3.6	3.6	2.8	2.5	5.8	5.7	4.3	4.1
1991	3.5	3.5	2.1	2.0	5.6	5.5	4.0	4.0

REAL GNP AND TREND



Senator D'AMATO. I was wondering, Mr. Chairman, if I might—and Congressman, I am sure that you have always been quite considerate—if I might renew my first question to the Chairman in regard to how and what impact he views the pending tax legislation and whether or not I am unduly concerned with what I characterize as a chilling effect on business investments, given the uncertainty not only of the legislative provisions but of the date, and shouldn't we attempt to do what we can to minimize that chilling effect by setting a date that is a certain in the future?

January 1, 1987, is what I have suggested.

What is your view?

Mr. SPRINKEL. I share your concern. Investment decisions tend to get delayed in an environment of uncertainty, and that carried to extreme would suggest that you can never change anything because any time you try to change uncertainty is created. I wouldn't want to go that far.

But on the other hand, there are things that the administration, working with the Congress, can do to minimize the risk of the change, certainly with respect to the timing of the provisions that may be adopted. I believe that Director Miller of OMB has made some statements along those lines. I am quite certain that the administration will be very pleased to work with interested Members of the Congress to try to minimize that potentially adverse impact.

Senator D'AMATO. I wonder if I might pursue that with a degree of particularity as it relates to the financing or the lack of financing activity that has taken place throughout America with respect to just about every municipality.

Is the Chairman aware that you grind it to a full halt? And we are not talking about industrial revenue bonds, we are not talking about optional kinds of things. We are talking about provision for roads, bridges, highways, hospitals, sewage treatment plants. All of those to some extent have been abated.

Does the Chairman intend to make any recommendations to those in the administration who deal with this?

Mr. SPRINKEL. Well, each meeting that I have attended in which that issue was discussed, a conclusion was reached that we should move with the Congress to try to minimize and reduce that kind of an impact. I will be glad to take another look at it and make sure my views, which are quite sympathetic to your own, are conveyed within the administration, and I hope that we can find people on the Hill that can make it happen with us.

Senator D'AMATO. Well, let me just conclude by saying this, Mr. Chairman.

I think we have got a serious problem, and there is no way you are going to hit 4 percent GNP unless the administration is willing to ask Treasury to come forth and say, look, regardless of what the final outcome of the tax legislation will be, let's send a clear signal that we want business to continue; the fundamental investments for the infrastructure and running of our cities cannot stop and be abated. And that is what is taking place.

And so I would hope we would work together to correct that immediately because we are going to wind up building a recession. We are not going to have a 4-percent GNP. So we have a dangerous situation.

Again, let me thank you again for your usual courtesy, Mr. Sprinkel.

Mr. SPRINKEL. Thank you, Senator.

Representative SCHEUER. Mr. Chairman, let me—I have a lot of questions I would like to ask you, but I would prefer to put most of them in the record in the interest of time and simply ask you four or five at this point.

First of all, on the impact of your projections on what we have to do on the budget for the next year. This year you project 4 percent growth. The administration says we have to cut $38 billion on the basis of that assumption, and the administration says that it has reached a $144 billion deficit in the budget it submitted yesterday.

Chairman Gray of the Budget Committee told us in the whip's meeting this morning that their estimate of the administration's budget is that over a 5-year period it is underestimating spending by $60 billion in the military budget, that in this coming year alone it is underestimating the actual spend-out rate of the budget for the military—or for the Pentagon by $15 billion.

If that were the case—I don't know if it is true or not, but if it is the case, it would mean that the deficit which had been submitted yesterday would be $159 billion rather than $144 billion. Then if you assume that you are off by 1 percent or so in your projections, that could add an additional $20 billion to the deficit, necessitating an additional $20 billion in reductions because we would be at $179 billion instead of $144 billion.

What will happen is that we will proceed from now until August on the assumption that somebody's numbers are right. If we follow yours, we will cut $38 billion. If Mr. Gray is correct about what has happened on the military side in the administration submission and if you wind up being off by less than the average error rate over the past 5 years, we would cut $38 billion, reach all of the accommodations in the Congress and between the Congress and the administration and in society if it is necessary to reach that number.

And then we wake up, come August, and say, sorry, boys and girls, you got to do it all over again in the same magnitude, and you have to reach another $30 billion in cuts or so. What can you point to as hard evidence that your projections this year—or that we can have a great degree of confidence that your projections this year in terms of growth rate are going to be any closer to the mark than we have seen the past 5, 7, 8 years?

Mr. SPRINKEL. Well, first, as you are well aware, no one has the power to see the future with certainty, no economist and no one else. Even when you talk about the past, there are great difficulties because the numbers are frequently revised.

Representative SCHEUER. Yes, but if I——

Mr. SPRINKEL. So you do not even know for sure what has already happened.

Representative SCHEUER. But if I could interrupt, the reason I bring it up is because this is different.

Mr. SPRINKEL. I understand.

Representative SCHEUER. In the past if you were wrong and we were wrong, nothing happened.

Mr. SPRINKEL. Right.

Representative SCHEUER. This time something is going to happen.

Mr. SPRINKEL. That is correct, and I think you can have considerable confidence in our forecast, but one can never have 100 percent confidence in any forecast. My confidence in our forecast has improved significantly since the time we issued it. At the time we issued it and up to recently, it was very clear to me that there was evidence that all of the early foreshadowing events that occur prior to an acceleration of activity were in fact in forward gear. We projected an improvement in income, we projected an improvement of industrial production, we projected an improvement in corporate profitability. Since the time we issued the forecast these events have occurred.

In addition to that, we anticipated some decline in oil prices, but did not anticipate the very sharp decline in oil prices that has occurred over a relatively brief period and to a very substantial extent. The net effect on economic growth—and that is what we are talking about at the moment—is clearly a strong positive. If we have a $10 decline in oil prices, for example, this would have the effect of adding maybe as much as 1 percentage point to economic growth over a year. Therefore I think you should look upon the target of 4 percent real economic growth, fourth quarter to fourth quarter, as highly probable. We will take another look at all the data come next August and reconsider our forecast, but my guess is that we will not be revising downward. I do not know whether we will revise upward or not, but my own confidence is quite high.

Representative SCHEUER. What——

Mr. SPRINKEL. And I should add, Congressman, that I hear from the reporters and some of the economists that I have talked to—and you might check it with the gentlemen that are going to follow us—that most of them are revising their numbers upward, and that is what I think should be done because the average forecast until recently was around 3.1 percent.

Representative SCHEUER. Well, then should you, too?

I guess what I am asking is if what you are telling is significant because of what has happened on oil, that you think things have improved since you made your forecast of 4 percent, would it be wildly out of sight for the Congress or CBO, if they agreed with your initial assumption, to assume therefore that because of what has happened on oil that we might see, say, 4.5 percent growth and You might need less in deficit reductions to meet $144 billion?

Mr. SPRINKEL. We will not change our forecast now because there is not enough evidence. You know, something may happen on the oil front that would prevent it feeding through into real growth. But it is working in the direction of increasing my confidence that our initial forecast will be achieved.

Representative SCHEUER. When you built your forecast, what was the growth rate that you assumed for M1?

Mr. SPRINKEL. We, of course, know what the growth—with a fair degree of certainty—what the growth rate in M1 has been over the last year or so. It has been on the order of 12 percent, beginning a year ago last fall and continuing up to the present. We made some estimates as to what that is likely to do, given the changes that have occurred in the trend growth of velocity. We looked at the supply side to see that we had adequate resources, including labor

as well as capital resources, to make possible the response in output. We know that in the short run changes in monetary policy impact primarily the real sector of the economy and in the longer run affect primarily the inflation sector of the economy. It is our expectation and hope that over the next few years that monetary policy will gradually become a little less expansive so that we can keep inflation low and bring it lower.

Representative SCHEUER. But for this coming fiscal year, what was the growth rate that you assumed in that year?

Mr. SPRINKEL. The other point that I should have made is that what happens to money growth today affects spending out there 6 to 9 months from today, so that money growth to date certainly will take care of the first two or three quarters of 1986. We do not anticipate that there will be a sharp contraction in money growth in the period immediately ahead. Otherwise, it could create problems by late this year or early next year. We assume there would be gradual, very gradual deceleration in money growth.

Representative SCHEUER. But what was the number that you took?

Mr. SPRINKEL. About 12 percent for 1985. We have not published the number that we used in the forecast, but we certainly have published the basic view about what is necessary to keep inflation down and to bring it lower.

Representative SCHEUER. Mr. Chairman, we have a rollcall vote, and I am going to go over and answer that. I do have a couple of questions that I want to ask the witness, but if you expect to excuse him in the next few minutes——

Representative OBEY. No, no, go ahead.

Representative SCHEUER. I would simply ask unanimous consent that members be permitted to ask questions in writing.

Representative OBEY. Absolutely.

Now, I had asked a couple more questions and try to make it on the second round and then come back for whatever questions people might still have.

Representative SCHEUER. All right. Well, I will zip over and come right back.

Representative OBEY. OK.

Mr. SPRINKEL. And I want to respond to your deindustrialization and productivity question——

Representative SCHEUER. I appreciate that.

Mr. SPRINKEL [continuing]. Because we did cover it in the report.

Representative OBEY. But you don't want to indicate to us what number you used in estimating what M1 growth would be for the coming year?

Mr. SPRINKEL. I don't remember the precise number. I remember the general direction was a moderate decline in the rate of growth. So, if you had to pick a number, decelerating downward moderately.

Representative OBEY. Please excuse the chopped up nature of this hearing. It is another of these essential rollcalls. The last one was passing 161 to nothing when I voted. [Laughter.]

Mr. SPRINKEL. Somebody wasn't needed, huh?

Representative OBEY. And I assume this is another holy pictures rollcall.

Let me ask you this. Let us assume—I know that you and I have had a conversation about this once before, but let's assume that we cut everything the administration wants to have cut out of the domestic side of the budget this year and we get the $38 billion, and the President gets his budget passed basically by August.

Then let's assume that economic growth is 1 percent slower than you estimated, and assume at that point that the President says, no, I don't want any further reductions in the military budget, and assume that the Senate and the House say we have cut what we are going to cut on the domestic side, we have already taken all the cuts this year and the President has received his defense number, but we are still $15 to $20 billion away on the deficit.

At that point, in your judgment, what is the most important consideration for us to stick to—reducing the deficit by another $20 billion or backing away from the President's position that there should be no revenue increases?

Mr. SPRINKEL. Well, first, the probability of all those things happening I think is fairly low. I heard the President being asked this morning as to what was the best birthday present he could get, and he mentioned the cooperation of the Congress to get his budget passed as well as his other initiatives.

Now, it is true that it is possible that all those things would happen except that instead of 4 percent growth, we achieve 3 percent. I think it is very unlikely, but it could happen. I would say the thing you should keep clearly in mind is not to do something to adversely affect growth if that were to happen. The major reason the President has been adamant about not having a tax increase is that very concern, that he does not want to slow growth, create adverse incentives to working, saving, and investing and make it even more difficult to create opportunity for those that are having difficulty.

Representative OBEY. Mr. Chairman, the problem 435 of us are going to have in the House is we are not going to have a chance to give that speech when the rollcall button goes on. We are going to pull out that card, and we are going to hit the red button or the green button, and we are going to have to make a choice or we may very well have to make a choice between hitting the deficit target and accepting revenues. What I am asking is: Assuming that both of them are bad business from your standpoint, which is worse, to not hit the deficit target that Gramm-Rudman prescribes or to swallow some increase in revenues?

Mr. SPRINKEL. I don't think those are the only alternatives. Gramm-Rudman is the law, and the President was very careful to comply with that law, and I assume the Congress will be very careful to comply with the law. So that is not really an option unless you want to change the law.

We are in favor of that law. We strongly supported it. We think it will have strong positive effects on the economy. It will permit resources to be utilized in the private sector that will create growth opportunities that do not occur when they are in the public sector. So we are strongly supportive of the law, and we do not want you to change it.

We do want the restraint on spending without tax increases. We believe that economic growth will be sufficient to make it not a

painless task—even $38 billion is not painless—but at least not draconian.

Furthermore, if the Congress will pass this budget——

Representative OBEY. Yes; but I am not talking about $38 billion. I am talking about assuming that the consensus economic forecasts outside the administration are more nearly correct than yours and that it would require another further reduction.

I mean, what I am talking about is I think what everybody believes is the point we are going to get to, and we are going to have to make that choice, and I think what I hear you saying is if that is the case then you would rather just let sequestration go into effect than to have any other movement?

Mr. SPRINKEL. No; if you asked me my preference, we have no objection to the Congress cutting more than $38 billion if we can do it within the constraints that the President has laid out. There is nothing wrong with running a surplus in the budget.

Representative OBEY. With 70-some percent of the budget off limits?

I know the members have more questions to ask you, and I have to get over and vote. This is an adjournment motion. [Laughter.]

Mr. SPRINKEL. Very important.

Representative OBEY. It is because it's for the Lincoln Day recess. [Laughter.]

Mr. SPRINKEL. Right. I'll wait for you, sir.

[A brief recess was taken.]

Representative WYLIE [presiding]. As you know, the Joint Economic Committee is a nonpartisan-bipartisan committee and members can take over [laughter] regardless of their party affiliations.

I think maybe what we'll do—I know you are on a close timeframe here. Maybe I'll ask my questions and then, when Chairman Obey comes back in, I'll turn the gavel over to him.

And I'm sorry that I didn't hear the last of your testimony. We just voted on whether we were going home for a Lincoln-Washington Day recess or not. And that's the big issue right now, as to whether we should stay here and work on the Gramm-Rudman or whether we should go back and give some of those speeches.

In chapter 6, page 189 of the Economic Report of the President, the role of the Federal credit markets is addressed—loan guarantees, housing finance, and so forth.

But it doesn't mention the possible problems of energy loans as far as some of our major banks are concerned. And I'm asking this question in honesty. I was asked the question by a group of bankers that I met with back during the recess period.

What is the financial soundness, in your judgment, of those financial institutions, the U.S. banks, that made a lot of energy loans?

And I don't know. If you want to make a suggestion as to what, if anything, the Banking Committee should do about it, I'd like to listen.

Mr. SPRINKEL. Well, the major comment we made concerning the ability of the financial institutions to survive what turns out to have been bad credit decisions relates to both what we believe is the overregulation of banks which prevent them from diversifying their assets adequately, and also the inflation-disinflation process.

Now, we do have some problems remaining. It's not nearly as bad as it was in the early 1980's when I was in Treasury, when any proper accounting of many financial institutions showed they had negative net worth. The decline in interest rates that has occurred, the gradual writeoff of some of the loans, the rise in profit that has allowed rebuilding of capital, all of this has made the situation stronger.

Now, with respect to energy loans, there are some banks that are heavily concentrated in the energy area. And the recent decline in oil prices and presumably other energy prices will not strengthen those loans. They will make them more difficult to work out. In some cases, they will have to be written off. In others, perhaps the terms will have to be lengthened and changed. As you are well aware, Congressman Wylie, we do not believe it is the role of the U.S. taxpayer to pick up the cost of past mistakes. It is our role as a government to try to create an economic environment that will not lead to additional, similar mistakes in the future. But I do not believe that the financial system as a whole is in great difficulty even as compared to the recent past. We think it's a strong system, but there remain problems. And we tried not to duck those problems in reviewing them in the Economic Report.

Representative WYLIE. I'm not taking over, Mr. Chairman, but in the interest of time, I thought I'd go ahead with——

Representative OBEY. Good. Good.

Representative WYLIE. Were you in the middle of some questions that you wanted to continue with?

Representative OBEY [presiding]. Go ahead where you were.

Representative WYLIE. You said that part of the problem is the U.S. banks and their foreign investments had to do with over-regulation.

Is that what you said?

Mr. SPRINKEL. I said that, in our opinion, the heavy concentration that occurs in certain assets of certain banks is frequently due to the fact that they do not have the ability to diversify over a larger geographical area and, consequently, this inability has increased the risks that they have incurred. We believe that we, working with the Congress, should continue to work toward regional banking and, ultimately, nationwide banking which will permit the diversification of those risks much more efficiently than is now the case.

Representative WYLIE. But that doesn't apply in the same degree in foreign loans as it does in domestic loans?

Mr. SPRINKEL. No, sir. That's correct. That will not help diversification of foreign loans. Avoiding another sharp inflationary period followed by disinflation will help to avoid mistakes next time. But, in the meantime, we do have an international initiative that we believe will gradually make those loans somewhat better and, certainly, the health of the LDC's better.

You may remember Secretary Baker's initiative, which is based on the view that we need to keep our economy strong so that healthy demand for LDC's exports will be maintained. At the same time, we want to encourage progrowth, noninflationary policies in the LDC's. Moreover, providing some credit both from private and international public institutions, over time, can improve the situa-

tion. But, if there are any quick fixes, I was unable to find them when I was in Treasury and I don't think they exist.

Representative LUNGREN. The decline in oil prices, of course, has had a harmful impact on a lot of our U.S. banks which invested heavily in oil. I think they were encouraged to do that, perhaps even by governmental policy at the time.

But does that give us an opportunity, maybe a payments opportunity, to try to help resolve this budget deficit crisis we're in?

There's much talk about an oil import fee right now. Have you spoken to that?

Mr. SPRINKEL. I have, at this meeting. We have thought a lot about it. As you know, the President has made it very clear that he would not consider a tax increase in the process of meeting the Gramm-Rudman-Hollings targets. And the reasons I did explain very briefly. Namely, a tax increase would be prolarge government because it would reduce the constraint on spending, and it would weaken the private sector. So I think the President—I heard him say it again this morning—is very clear on that point. He has stated that he would consider, but he has made no decision on, whether or not an oil import fee in conjunction with a revenue neutral tax reform package should be considered.

It's very clear that one can make fairly straightforward statements about the economic impact of an oil import fee or tax. And I'll be glad to touch on what I consider to be the major effects. That doesn't quite answer the question as to whether or not it is wise for you and the administration to consider it as policy. But it's very clear to me that the imposition of an oil import fee would have significant adverse effects on the U.S. economy. It would be a strong deterrent to growth, depending on how high the fee. It would tend to increase our costs of production relative to the rest of the world, assuming they're not adopting the same approach—and I haven't heard of other major countries that are considering it, especially for energy-intensive industries.

It would tend to deter improvement in our trade balance, which is in a difficult situation as it is. It would tend to strengthen the dollar, which makes it a little harder to export goods. It would tend to reduce the ability of the economy to grow and create jobs because, instead of letting the cost of energy come on down, the effect of the import fee, of course, would be to hold the price of energy up.

So it's, in my opinion, antigrowth, antifree trade, because this is a protectionist measure. It further distorts the decisionmaking process, which will penalize the country. It will increase the cost to the East and to the Midwest, which are not energy producers of quantity, but it would be to the benefit of certain other sectors of the economy. So it's a drag on growth—bottom line.

Representative WYLIE. So, as the President's Chairman for Economic Advice, you're advising against——

Mr. SPRINKEL. I would never indicate what I advise the President. [Laughter.]

I never indicate publicly. I have advised the President, and very recently, on that issue.

Representative WYLIE. What he says, we'll consider as of this point, that's a slight modification from his earlier position.

Mr. SPRINKEL. It might—it probably is. I would have to check the record, but I think it's a slight modification, but it should not be read to conclude that he will do it. He specifically indicated very recently that he would look at it.

Representative WYLIE. Thank you. Thank you, Mr. Chairman.

Representative OBEY. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Mr. Chairman, in the interest of time, I would ask unanimous consent, as I did before, to ask the witnesses some questions that perhaps they could answer in writing, and that we try and get them the questions today.

I might have one or two questions to which I'd like to have an answer today, but most of them will be for the record and I would ask them to answer in writing.

And it's about the question of productivity. I haven't had a chance to read this as thoroughly as I would like, and as thoroughly as I will, but I didn't notice—you do have a section on protectionism and perhaps that involves—I haven't read that thoroughly either—some consideration of problems of productivity and our problems of competitiveness.

But let me just ask you specifically, and I apologize if you alluded to this matter while I was out catching votes.

What would be your recommendation to the President, or what would be the policy of this administration, on improving our productivity and improving our degree to compete as serious global actors in the world competition?

And I would break that down into a couple of—incidentally, I see a couple of our other witnesses, and I'm going to ask them the same questions. And so they can listen or not listen, but they'll get the same missive in the mail. And I'd like very much to get their answers. [Laughter.]

And if we have time, I'll ask them some questions later.

Breaking down the question of productivity into its component parts, how do we improve corporate decisionmaking? How do we encourage corporations to take advantage of the benefits that we do give them—the quotas, the restrictions on imports—to help them make it?

We've seen steel and autos enjoying all kinds of protective benefits for a period of time. And, at the end of the time, they were just as badly off as they were at the beginning of the time. They didn't seem to use that period very productively except to engage in some oil purchasing ventures outside the orbit of their normal activities.

They seemed to continue the policy of eating into capital, failing to invest in research and development, failing to invest in new plant and equipment, so that, at the end of the period of the benefits, they had to come pleading to Congress for help to keep them viable.

There's very little evidence that the help that we gave them made any permanent difference.

How do we change those corporate attitudes and the quality of corporate decisionmaking? Labor, too. How do we upgrade labor scales? What do we do about the monumental problem facing American productivity of adult literacy, adult illiteracy? Where do we break into that?

Should we be thinking of the corporation, the work place as deciders for education? If the schools have failed and we have an 18- or 20-year-old functional illiterate, is there some program that you would recommend to give these young people job training and illiteracy training at the point of work? Would there be compensation? What would the incentive be?

Would the administration direct any specific programs and projects and research to the problem, the problem of adult illiteracy and the upgrading of labor skills in general?

Next, and perhaps most important, the question of savings and investment. The Japanese have a level of savings two or three times ours.

What kind of incentives do we get to convince the American people that we ought to end this orgy of consumerism, and direct a greater flow of their assets and their net worth into savings and, therefore, into production?

How do we end the overinvestment in housing? If you compare the per square feet that the average American enjoys in housing and the level of amenities, it's an astronomic figure ahead of the other developed countries that are preceding beyond us in per capita GNP.

How do we direct some of that investment away from the fields that are noncompetitive with global competitors, mostly in the field of real estate, where we're giving major tax encouragements in terms of the accelerated depreciation and the investment tax credit for new hotels, new highrise apartments, new office buildings, new shopping centers—that we really are not in desperate need of—while our industrial sector is starved for investment?

How do we give more tax benefits, more incentives for investment in the industrial sector, which is in fierce competition with tough, competent, brilliant and motivated competitors from abroad?

Last, a question, in looking over the range of taxes that have been talked about, and including by leaders of the Senate majority—not just the energy tax at our borders, but the value-added tax perhaps in some form, the possible minimum tax on the wealthy corporations and wealthy individuals in our country, who are virtually escaping taxation; where, if we aimed a tax at them, the vast middle of that barrel in our country would not be affected at all.

Now I'm going to ask a question directly taken from your economic report, for which I'd like an answer if you have one.

You have a horrifying statistic in terms of human suffering and human degradation on page 77, first full paragraph, where you say:

"Low income countries in Africa suffered an 8.7-percent decline in average real per capita income in those 4 years." And you're referring to the years from 1980–84. The first full paragraph on the top of page 77.

Well, a lot of us knew that was going on because a lot of us knew that birth rates were going up in Sub-Saharan Africa at the rate of about 3.5 percent. And food production was going up about the rate of 1 percent. But I never put it altogether to come up with a cumulative 8.7-percent decline in average real per capita income in Sub-Saharan Africa. That is a——

Mr. SPRINKEL. Which was a low in the world, to begin with.

Representative SCHEUER. Of course. And that is a truly horrifying statistic. If you want to take an economic statistic that spells pure, unadulterated human misery and human degradation and human suffering in its purest form, you have given it to us.

A country like Kenya has just about exceeded the highest, what we consider theoretical population growth, which was about 4 percent a year. Now we think they're at 4.2 or 4.3 percent a year because they've gotten the benefits of radically reduced mortality from Western public health advances that we've given to them generously, but very little in the way of reduction in human fertility.

It's been said by this administration that these things are sort of self-governing. And that economic development is the answer to population growth. And we don't need any outside intervention in terms of government-supported, government-assisted family planning programs.

Is there a lesson for us in this horrifying figure that you've given us? That we don't have time for this figure to reverse itself. And in countries that are suffering close to 9 percent cumulative reduction in their per capita GNP, with little evidence that that is going to be reversed in the near or even the middle run, that we have to intervene at least to give them a chance to get hold of themselves and create some kind of bootstrap operation by giving those young couples a chance to moderate their fertility?

So that the median woman in Kenya by the end of her childbearing years doesn't have 8.7 percent fertility, but has something nearer 2 or 3—doesn't have 8.7—exactly the same statistic, the same figure—doesn't have 8.7 children at the end of her childbearing years, but has something nearer 2 or 3, so that that family and that country can begin to create some capital and improve its per capita GNP?

Does this figure justify a change in the administration position on our family planning aid overseas, is what I'm asking?

Mr. SPRINKEL. In my opinion, it justifies the basic thrust that we have attempted since at least January 1981, and perhaps in prior administrations, to encourage nations to move toward policies that will permit growth there, too.

Now, many of these countries start from extremely low levels and, therefore, they do not have the bureaucracy, the ability to execute the kinds of a policy that we might think about in industrial countries. And, therefore, through the institutions, we have developed ways of providing aid to them, both bilateral aid as well as multilateral aid. But, aid, in and of itself, unless it leads to the kinds of organization of society that promotes growth, is not a panacea. Many of these countries seem to continue to stay at the edge of abject poverty irrespective of their birth rates. Malthus wrote a book on this a long, long time ago and, although it didn't turn out to be totally correct, it still looks like a reasonable hypothesis in some parts of the world.

It is important that we promote the kinds of policies that will encourage growth. So I don't think it suggests that a change of our basic views is needed. We do lay out—because I'm interested and I'm concerned—for the first time in this report, I believe, a rather extensive review of the literature to see what kinds of policies have worked. I hope it will strengthen our ability to convince the rest of

the world that this is the way they too can grow faster than they've done in the past.

So, from an economic policy point of view, I think it means we have to continue to do a good job of conveying our concerns, our willingness to help, but also our insistence on performance in terms of their own economies. We can do that through the international institutions, and we do. We can do it through our bilateral relations, and we do. The great difficulty is that, frequently, it's resisted—partly because perhaps they don't understand, partly because they fear domination. So we have to do it in a way that they understand it's in their best interests, not just our best interests.

Could I back up to a broader issue you brought up on productivity? I want to talk about some of the broader issues, and then you raised some issues in the labor area and educational area.

Representative SCHEUER. Mr. Sprinkel, with all respect, I respect your concern, I respect your views. I may differ with you somewhat, but I respect your obvious concern.

If you would be kind enough, I would request you to answer that whole raft of questions on productivity and competitiveness in writing, because——

Mr. SPRINKEL. OK.

Representative SCHEUER [continuing]. I've abused the chairman's patience.

Mr. SPRINKEL. I'll be glad to.

Representative SCHEUER. And I promised him that I would proceed along those lines. So I'd appreciate it if you would——

Mr. SPRINKEL. I was going to toss part of them to Mr. Moore. I want to get him on the hot seat.

Representative SCHEUER. I'd be very happy to have him participate in your written answers. Thank you so much.

Mr. SPRINKEL. Thank you, sir.

Representative OBEY. Thank you.

Let me just ask you two other questions before we try to move on to the next panel.

Again, getting back to the crucial nature of your estimates, one of your projections is that productivity, which Congressman Scheuer's been talking about, would rise. You indicate you expect it to rise by about 1.8 percent, this year?

Mr. SPRINKEL. Yes, this year.

Representative OBEY. The administration's projection for productivity increase last year was 1.7 percent, I believe. And we wound up having close to zero.

Again, what is there? What changes do you have by way of tools available, by way of how you're reexamining what's been going on in the economy that would lead us to believe that we could have any more confidence in that number than we could have in that same number last year? Outside of the fact we have a different chairman. [Laughter.]

Mr. SPRINKEL. The first point I would make is if you relate measured productivity—and I say "measured productivity" because we don't measure it very well, for lots of reasons—but if you relate changes in measured productivity to changes in real growth over a business cycle, or over several business cycles, you will find an in-

teresting relation. It has nothing to do perhaps with longrun forces, but it has a lot to do with how those numbers are measured.

You will find, for example, that when economic growth accelerates, which I have argued we are now seeing and will see in the months ahead, inevitably, measured productivity goes up significantly. Conversely, when you have a significant slowdown—and the worst of all is going into a recession—you will find weakness in measured productivity. This says that if you sustain good growth over a considerable length of time, those oscillations will not occur. Much more fundamental to why productivity goes up is what you can do to encourage capital formation. If we are going to make labor more efficient, we need to create an environment that is conducive to saving, investing, and profit potential. We've done a lot in that direction.

Representative OBEY. We understand that. But, my point is, what is there—I'm not talking about what have you done that can make it grow this year when it didn't grow last year. What I'm asking you:

What new is there out there that can lead us to have a greater degree of confidence in that number this year vis-a-vis that——

Mr. SPRINKEL. I perhaps did not state it persuasively, but I will restate it. Last year, we had a slowdown in economic activity. Growth was still positive, but there was a deceleration from the previous year. That is typically associated in the short term with a slow down in measured productivity. This year, for the reasons I gave you, we are almost certain to have an acceleration in economic activity and measured productivity will rise. That is the short answer. That is what is different this year versus last year.

Representative OBEY. OK. Let me ask you this one last question. I must say that the more I read that he writes, the more I am often in agreement with Kevin Phillips. And I'm sure that would be as disconcerting to him as it is to me. [Laughter.]

But when he appeared on a panel at the symposium that the committee ran, he—and I say this because I'm real interested in the accuracy of your view of the world and how it works, because it relates very directly to competitiveness.

And not just the competitiveness that Jim is talking about in terms of what we invest in the human factor in the economy, but the way we do position ourselves and organize ourselves as a culture to defend our national interests as opposed to selective defending of individual corporate interests abroad, let's say.

And in the paper that he presented, and I'm going to quote a number of paragraphs from it, he says that—he describes the chilly reception the White House gave to the 1984 Report to the President's Task Force on International Private Enterprise in the early 1985 Report to the President's Commission on International Competitiveness. And he goes on to say this:

> The largely ignored task force report urged the White House creation of an Economic Security Council to plot U.S. global economic strategy in the manner of the existing National Security Council.

And the Commission followed by calling for a new Federal department to orchestrate international trade, and another to deal with science and technology.

Such new instrumentality may well be necessary for this administration or any other to coordinate trade, tax, budget, monetary policy and their collective domestic and international impacts.

He then went on later in the paper to say this, and I know that you're a passionate believer in the free movements of markets and in free trade—you refer to that in chapter 3 of your report. I'm basically a free trader, and I basically believe in free markets, too.

I also believe that some day the Chicago Cubs are going to win a pennant before I die. [Laughter.]

But, Phillips said this:

Open markets are a precarious phenomenon. For one thing, a serious perusal of modern history defined in the period of the Cambridge modern history as beginning in 1493 suggests that free trade may be a latter day abberation. Free trade is not necessarily a norm. U.S. policymakers cannot afford to assume it is a probable or logical state of global affairs.

And then he goes on to say:

Much more is involved than transient currents in this alignment of pressures. Under pressure of global neomercantilistic realities, even some U.S. free trade economists have begun to wonder if their purely economic interpretation of the doctrine of comparative advantage, that goods are produced where economic advantage dictates, may not have to be modified to allow for the benefits of a collaborative national government.

And then he went on to say:

Under the circumstances, Washington's strategic abdication has become intolerable.

I'd like to know what your evaluation is of those comments.

Mr. SPRINKEL. Well, it would be very helpful to me if I had read them in context and, therefore, I cannot be certain that I understand what Mr. Phillips is saying. But, on the first point, it seems to me he is saying that we do not have machinery within the White House and within the administration capable of formulating and executing international economic policy. And that is just wrong if that is his implication. That is the impression I have from the excerpt you gave.

I'll be very glad to explain how it works and why it works very effectively, and is guided by the basic principles of the President and all decisions are made by the President. I'll be glad to do that.

But, before one proposes some other new organization, I think it behooves one to make sure that the one you've got isn't working. And I think ours is working very well.

Representative OBEY. Well, I think he's saying two things. I think he's suggesting that the executive branch is not organized with the degree of focus he would like to see on those issues.

But I think he's also raising the question of whether or not we can continue to function in a rigid adherence to the belief that faith in free markets alone is an effective way to defend our national interests when other arrangements may be followed by other countries and specific sectors.

And I guess my concern is, given your well-known views about the importance of keeping government out of everything, if possible, my concern is:

If his view of what is happening in the world is correct, how can we eventually get to the kind of sustained economic growth that you are projecting in your report for future years, given what I be-

lieve to be a rigid adherence on the part of this administration and some segments of the Congress to following policies that don't reflect what international economic realities sometimes are.

Mr. SPRINKEL. Well, Mr. Chairman, I think our policies have been very reflective of international realities. We do not believe that the experiences of today negate all of what we have learned from history. We have attempted to incorporate the principles that have been developed in the past into our thinking. For example, the fact that we have become a rich, powerful nation in no way reverses something Adam Smith pointed out 200 plus years ago of the relative advantage of trade. And the mere fact that the world is richer and the volume of trade is larger and that there are problems related thereto does not mean that, in my opinion, we should forget about moving toward freer trade. It's true we don't have free trade. We never have had free trade. We never will have free trade. But we can move toward an objective and can try to get as far as we can.

Now, this year, the President has added to his basic views that free trade is the proper way to go. Why? Because it contributes to growth and improved opportunities. He has added the idea that it also needs to be fair. If it isn't fair, we gain from keeping our markets open in any event. But if we can get others to open their markets so that we have a level playing field around the world, we gain more, as they also do.

That is the effort that we have been pushing for quite some time. There was an administration white paper on trade policy that I hope was read in the Congress. I saw very little reference in the press, to my amazement. It was the result of many months of efforts by various agencies, including my own group, and it laid out the basic policy thrust of this administration; how we are approaching on several different fronts the resolution of some very difficult economic problems that have been incurred partly because of the high U.S. dollar, partly because of poor economic performance abroad. So it's unfair to say that we haven't thought about these issues. We have a policy. We are pursuing it. And we plan to continue pursuing it with the help of the Congress.

Representative OBEY. Well, I won't—you've got your view and I've got mine. Let me just add that my concern is that I don't believe the administration has sufficiently focused on the kinds of concerns or, for that matter, some of the recommendations made by the President's Commission on Competitiveness, for instance.

And I don't believe that the strong adherence strictly to the faith in free market forces, without some other actions, whether they be in terms of developing the quality of our work force in this country through investments. I don't think this administration is willing to make thorough realistic adjustments to reality on the international front in terms of trade, whether it's through a value-added tax or anything else, by way of improvement of the position of our competitors versus their competitors. I just don't believe the administration has been sufficiently nonideological in its response to those problems.

And I know we differ on that.

Mr. SPRINKEL. Yes, sir, we can differ. But we eventually judge who is right by economic performance. And I think the perform-

ance of our economy over the last 3 or 4 years has been excellent. And, with your help, we're going to make it continue to be excellent in the future.

Representative OBEY. What is your projection for the trade deficit for this coming year?

Mr. SPRINKEL. I have not made one, but it will be higher than last year. And last year was $144.6 billion. In looking ahead, we must recognize two things.

First, the dollar has depreciated now for about a year. Accordingly, by the latter half of this year, there should begin to be monthly improvement in the trade deficit, rather than deterioration. We just published the alltime high merchandise trade deficit for 1 month for last December, $17.4 billion. It's getting worse every month. We think that by the latter part of this year, we'll begin to see some monthly numbers that are better, largely because it takes 1 year to 1½ years for the so-called J-curve to work out after a currency weakens.

Second, we are seeing some evidence of strengthening activity in Europe, particularly Germany. And sluggish growth overseas has been another one of our big problems. But the trade deficit will be higher for the year than it was this past year, and it will be 1987 before there is any real prospect of having a lower trade deficit for the year as a whole. Now, we should note that while trade deficits create problems, they are not the end of the world. We ran large trade deficits in our early history up until World War I. We were a net capital importer.

Representative OBEY. Yes, but then we were investing. Today, we're consuming. Given what's happened with capital flows internationally, I think it's a big difference.

Mr. SPRINKEL. Well, as I indicated, the ratio of gross private, domestic business investment to GNP has been at a historical high now. This economic expansion did not just happen. We are investing. It is just not all from capital that has been generated internally. That is, we are importing capital. But it is very clear to me that that capital is being husbanded rather carefully. And it is important that investment continue to expand so that we can continue productivity growth and real growth and opportunity for all Americans.

Representative OBEY. We've got second bells. Do you have any other questions?

Representative WYLIE. I just wanted to follow up one on productivity. I wasn't going to ask another one, but your question on productivity——

Representative OBEY. Excuse me. Let me go vote. And if members are finished and Mr. Sprinkel is finished, and Chalmers is finished, thank you very much for coming. And we will put on the next panel as soon as I get back.

Representative WYLIE [presiding]. I only have one more question.

But the question on productivity prompted a question in my mind.

What do you think about the tax reform bill in that there are rather significant shiftings of the tax burden from individuals to the business sector?

Mr. SPRINKEL. What I had intended to bring up with Congressman Scheuer was that very point. That fundamental to improving productivity for the future is having a tax system that will encourage capital formation. CEA did a lot of work on the President's proposal for tax reform with the primary objective in mind of trying to decide whether it is progrowth or not. That is not the only objective of tax reform, but it is an important one. And we concluded that the President's tax proposal is significantly progrowth.

The bill that came out of House committee has some significant weaknesses compared to the President's proposal. And one of them is that it substantially raises the cost of capital, which will clearly slow incentives for capital formation into the future. When the President indicated that he would veto that bill if it came to his desk in its present form, he also stated the areas where he wanted improvement. One of them was in terms of creating greater investment incentives. There were several others. But I agree with you. If we are going to have productivity improvement and rising standards of living, we must make certain that we continue to provide incentives for capital formation so that workers and capital can become more efficient.

Representative WYLIE. OK. That's all. Thank you very much, Chairman Sprinkel, and your testimony has been most impressive and I know that the chairman will join me in thanking you for your appearance here today.

Mr. SPRINKEL. Thanks, Congressman Wylie. I enjoyed it.

[A brief recess was taken.]

Representative OBEY [presiding]. Gentlemen, I apologize again for the delays. This last vote we had was another essential vote. It was at 191 to 1 when I left the Chamber.

Mr. THUROW. Were you the one?

Representative OBEY. No; we are all posing for holy pictures on freezes these days.

So next we have Mr. Alan Greenspan, president of the economic consulting firm of Townsend & Greenspan and former Chairman of the Council of Economic Advisers; Mr. Lawrence Chimerine, chief economist at Chase Econometrics; and Mr. Lester Thurow, professor of economics at the Massachusetts Institute of Technology.

Gentlemen, I had a lot of things I thought I would say in the introductory statement. I will put them in the record, and why don't we just get to your thoughts on where we are, where the economy is headed, how you view the administration's projections and let us hear what you have to say?

Mr. Chimerine, you want to begin?

Mr. CHIMERINE. Sure.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS

Mr. CHIMERINE. Mr. Chairman, I don't know whether this is a sign that Gramm-Rudman-Hollings is working, but these water cups are considerably smaller than they have been in the past. I would request that if the law——

Representative OBEY. Well, mine is leaking. So I don't know what that means. [Laughter.]

Mr. CHIMERINE. Yes; I would request that if the law is found unconstitutional you go back to the larger and sturdier cups in the future. [Laughter.]

Representative OBEY. If the law is found unconstitutional, they will be filled with champagne.

Mr. CHIMERINE. Well, that, too.

I am going to try to be very brief, Mr. Chairman. I will focus on the current economic situation and second, on some of the key issues in the outlook and the budgetary implications of the outlook as I see it.

And let me start with the situation as of right now. As you probably know, we have had about 18 months of extremely slow and erratic growth in the United States, and while I wouldn't characterize the economy as being in very bad condition, I think the health of the economy is being overstated by many people, including the previous witness. This is so not only because of the relatively slow growth over the last 18 months, but if you look below that at some of the underlying fundamentals, this recovery has been very disappointing in many ways. In particular, there is no evidence at all to suggest that long-term growth prospects have improved in recent years as a result of some of the policy actions that have been implemented.

In fact, quite the opposite has occurred; productivity growth, as you pointed out yourself a little while ago, is still very disappointing.

Net investment, which is the more relevant measure of investment, is not all that strong relative to historical levels. Savings, at least at the personal level, are the lowest they have been in the entire postwar period.

The deficit outlook, at least as of today, is still horrendous. We have an extremely unbalanced economy, with some sectors of the economy still in desperate shape and our competitiveness in world markets is probably about the worst it has been in our entire history.

So I don't see how anyone can characterize the current economic situation as being extremely favorable, or prospects for the long term as being very bright.

Now, in terms of some of the recent data, we have had 1 month's worth of relatively good data, namely, December.

In my judgment, anyone who uses 1 month's worth of economic statistics to make the argument that the economy is accelerating rapidly is taking an awfully big risk in view of how unreliable the monthly data have become. The seasonal factors around this time of year are particularly difficult.

We have had some special factors like weather and low interest rate promotions in autos which are distorting the numbers.

If you look at all the data, plus the anecdotal evidence that we get back from our clients, I think that the only conclusion you can reach as of this point is that, at best, a modest acceleration is underway.

There is no conclusive evidence yet to support the view that a major pickup in economic growth will happen. It might. But at this point, the evidence does not indicate that that process has begun.

Now, there are a number of relatively optimistic forecasts, including one you heard a few moments ago for 1986, and some of the optimistic forecasts are justified by one of the following:

First, the strong rise in the stock market and the wealth effects that that will produce.

Second, the sharp decline in oil prices that have at least on the spot market taken place over the last month.

Third, there are some who are arguing that the decline in the dollar is about ready to produce a sharp turn in the trade deficit.

Fourth, some base an optimistic view on the likelihood or the assumption of a big rebound in inventories, or inventory rebuilding.

And, finally, there are some that are basing it on the sharp increase in the money supply last year.

There are still some pessimistic forecasts, some arguing that the consumer is overextended and is going to have to cut back and retrench, and others pointing to evidence which suggests that capital spending is ready to weaken. Some are using one or both of those arguments to suggest a possible recession in 1986.

What I would like to do is very briefly focus on each of these issues that I have laid out and to describe my view of each, then put it all together. After that, I will address the key factors in the 1987 outlook, because, when you are looking at the budget, I think it is not just 1986 that is relevant. It is the two years together that will tell you how much you have to cut in 1987.

The first issue is the consumer. As you probably know, there has been a dramatic deceleration in income growth, particularly in wages and salaries.

In my judgment, this reflects to a great extent a mix-change effect, where we are losing middle-income and high-paying jobs throughout manufacturing, in part because of import competition. As a result average wages, adjusted for the mix change, has slowed very dramatically during the last 14 or 15 months. Spending has held up, although an increasing share is for imported goods, the net effect being that the saving rate has been forced down and that debt levels have risen substantially.

In my judgment, this is an unsustainable situation. You can't continue to have people buying Toyotas and other imports, and not creating an equivalent amount of income in this country, and expect spending to go on at that rate on a long-term basis.

As a result, I think you will see at a minimum significantly slower growth in consumer spending in 1986. There are two factors that will work in the other direction, but they are somewhat limited.

First, the stock market. Every study I am aware of indicates a very low marginal propensity to spend out of household wealth, in part because it is heavily concentrated. It doesn't benefit most of the population.

So even though the value of household financial assets has risen by about $500 billion over the past year or so, at best we will get $10 or $15 billion of added spending this year, and that is a very small amount.

Second, oil prices have come down. I don't think you should exaggerate the potential from this, although it is clearly favorable and

there is no question it will bolster economic growth and lower inflation.

However, the big effect comes from the decline in the price of imported oil. The comparable decline in domestic prices will have a significant offset in the way of reduced profits of energy producers and their cutbacks in exploration and investment and other expenses.

So the net stimulative effect on economic growth from declining domestic prices is considerably less than what it will be from import prices; that is, from the cost of imported oil, but we don't import as much oil as we used to.

Each $5 billion decline in imported prices adds about $9 billion to household income or profits in the United States. Even if you double that, it is $18 billion. It is not an insignificant amount, but by itself it doesn't suggest an economic boom in the United States in 1986.

In addition, all we have had so far is a sharp decline in the spot price. Contract prices will lag behind. There are also lags caused by the shipping and refinery delays. Thus, much of the stimulative impact on incomes and spending probably won't occur until the second part of the year even if contract prices come down to current spot price levels.

In addition, the world is not linear, and my concern is if prices go below $15, some of the negatives become more serious, such as potential banking failures and other bankruptcies in the United States, and this could start to have a negative effect on the economy, although admittedly, the decline in prices thus far will be favorable.

When you add all those factors together, I think we will not get a household retrenchment in 1986, but significantly slower growth in consumer spending is very likely.

The second issue is inventories.

Very briefly, I think some people are leaving the impression that inventories are low because goods are jumping off shelves quickly.

That is not the case at all. We have had a deliberate downsizing of inventories because the economics have changed dramatically. Because of high real interest rates, inventory holders lose money holding inventory these days, unlike the 1950's and 1960's, especially since leadtimes are low and there is a tremendous amount of excess capacity.

No one I am aware of is expecting to build their inventories dramatically in advance of a pickup in sales. So this will not be the leading edge in an acceleration in the economy.

The outlook for capital spending is also very guarded. Both the current leading indicators and the underlying fundamentals are not very strong.

We've experienced weakness in profits, slower growth in cash flow, tremendous overbuilding in most kinds of business construction, and we still have high real interest rates. At this point in the recovery, when most companies have already funded their highest rate of return projects, interest rates are having a bigger bite.

In addition, the stimulus from the 1980–81 investment incentives have already faded out. Some of our clients in fact are telling us that they have even completed a large part of their modernization

programs, which has been the only thing that has been pushing capital spending forward in the last couple of years.

And, current order rates, capital spending surveys, and appropriation surveys, all suggest very modest growth in investment at best. In fact, many of these indicators are suggesting negative growth.

So capital spending won't propel us forward dramatically in 1986.

Neither will trade, and this is perhaps the one area that I agree with Mr. Sprinkel. The trade deficit is not going to improve in 1986. The dollar hasn't dropped enough yet.

In fact, the last 20 percent strengthening of the dollar was irrelevant because all that did was widen profit margins of foreign companies in the United States—that is, foreign producers and their distributors. All the decline has accomplished thus far is offset that.

Import prices are only now beginning to rise, and not very significantly. Exports are weak. Export orders remain very sluggish. And the out sourcing of recent years hasn't fully shown up yet in the trade data.

Thus, while we may not see a worsening in the real trade deficit in 1986, it is premature to expect any significant improvement, especially since the dollar hasn't even declined relative to a large number of countries which account for a fairly significant part of our trade—these include some of the Far East countries outside of Japan and Canada, and many others. In fact, if anything, the U.S. dollar has strengthened against many of those, and these countries have become an increasing factor in U.S. trade in recent years.

So trade is not going to be a source of economic growth, in my judgment, this year.

Quickly, on housing, I think multifamily housing will decline. There will be some pickup on single family from lower mortgage rates, but there are some offsets to that. Overall, housing that will again, be a fairly neutral factor in the economic outlook.

And I don't see how anyone can take last year's increase in M–1 as a factor that will impact the economy in 1986. It is almost irrelevant—it is highly distorted, it overstates the easing in monetary policy, it neglects the high real interest rates that we still have—which is still a limiting factor on economic growth.

M1 was affected by a number of temporary factors, and by financial market deregulation, so that it is just completely irrelevant, in my judgment, as the basis of an economic forecast for 1986.

When I put it all together, I expect economic growth in the 2.5–3.0 percent range this year, with a different mix than in the last couple of years. I expect slower growth in investment and in consumer spending, but less drag from inventory liquidation and trade.

Oil prices may come down faster than I assumed in the forecast; if it does come down to the $15 or $16 level, that would get us closer to 3 percent real growth, but still a considerable distance from the administration's forecast.

I think the potential for faster growth in 1987 is greater, though, because if the dollar keeps coming down, if the Fed reduces interest rates like I think they will and should over the next couple of

months, and as the full impact of oil price declines feeds through the economy, the potential for faster economic growth in 1987 is greater than at any time, in my view, since mid-1984. We could potentially get 3 to 4 percent growth next year, even though there are some vulnerabilities in the economy, which I will get to in a moment.

My big concern about 1987 is now on the fiscal side, and it reflects both the potential for tax reform and Gramm-Rudman.

With respect to the budget, it is very hard to define a baseline deficit right now, Mr. Chairman, for the reason you mentioned earlier. However, I think defense and farm spending for 1987 are being understated.

Our view is that with more modest economic growth this year and with these other factors taken into account, a reasonable baseline deficit for 1987 is still in the $200 billion range, even with lower interest expense because of lower interest rates, which means to get to the $144 billion target, we would need close to $60 billion of budget cuts and/or tax increases.

My concern is that fiscal restraint of that magnitude in 1987 will have a significant depressing effect on the economy, even though it is desirable from a long-term standpoint. Reducing the deficit on a long-term basis will be favorable.

But you might remember back to 1983 and 1984. We had very rapid economic growth during the first year or two after we raised these budget deficits through tax cuts and spending increases, but the negative effects of the strong dollar and higher interest rates took longer to work through the system and have been the two principal factors holding down growth during the last 18 months.

It will work in the same way when we cut deficits. They will have a net depressing effect in the short run. The benefits from that will take longer to materialize, in my judgment. So if we cut the deficit too sharply next year, I think that would slow economic growth. It is also worth remembering that.

The recovery will be 4 years old. There is an enormous amount of debt in the system. I question how much additional debt households and corporations would be willing to incur, even with an easier monetary policy and even with lower interest rates, as a result of deficit reduction.

So again, I would think in the short run it would have a negative impact.

I would make the same point with respect to tax reform, especially to either of the two current tax reform proposals.

Both programs, in my judgment, would not be favorable on a long-term basis. Both would also have very nasty transition effects in the first year after enactment if they are not phased in. Thus, if we enact a comprehensive tax reform proposal in 1986, effective in 1987, in my judgment it would also slow economic growth in 1987 by causing sharp declines in investment and construction because if you take out the tax advantages for those kinds of expenditures when they are already soft, and with the already massive amount of overbuilding and excess capacity in the economy, you are going to have a sharp cutback in those areas immediately after enactment of tax reform.

In sum, I don't see how you can assume 4 percent growth for each of the next 2 years, such as the current budget projects. It is even more unlikely that we can have almost 4 percent growth on average for the next 5 years in view of the underlying fundamentals such as productivity growth.

Despite that, Mr. Chairman, I would be very cautious about 1987. This may be one of the few times in our history when economic forecasts will actually determine what actually happens in the economy because the forecasts will determine how much budget cutting you have to do next year, and if you cut too much I think you would only weaken the economy further and not even achieve your deficit target in 1987.

I think the risk of overcutting, by really curbing the effectiveness of various Government programs and cutting the deficit too quickly is greater than the risk of undercutting. So even though I don't see how we are going to get 4 percent growth for the next 2 years, I would prefer a more cautious approach in 1987 and not cut the $50 or $60 billion out of the deficit that might be required at the start of fiscal 1987.

One last point, I don't see how you can come even close to the deficit targets without some tax increases. In my judgment, the best way to do it would be to combine tax reform with deficit reductions. Raise revenues in the process. You should also consider modifying the tax reform proposals so that they aren't anticapital formation on a long-term basis, and in my judgment you should also consider phasing in some of the changes over 3, 4, or 5 years to reduce the short-term transition effects.

That would be my preferred way of raising taxes. My second choice would be some kind of an energy tax. My least favorable approach would—particularly for a small amount of money, $10 or $20 billion—would be a consumption tax.

A lot of people are overstating how much benefit we would get from a value added or other consumption tax. We have already implemented massive incentives for saving and haven't gotten any savings from them. People tend to forget, I think, there are a lot of people in this country who don't have that much flexibility—they are just struggling to get by and don't have the opportunity to increase their savings. And it will be a very, very costly and expensive tax to administer.

So that would be the least preferred approach for tax increases to reduce budget deficits.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

Prepared Statement of Lawrence Chimerine

My name is Lawrence Chimerine, Chairman and Chief Economist of Chase Econometrics. I appreciate the opportunity to testify before the Joint Economic Committee on the key issues in the current economic outlook.

Summary

In sum, my views are as follows:

(1) The U.S. economy has experienced relatively slow and erratic growth since the early summer months of 1984. While the December statistics were much stronger, it is premature to conclude that they represent the start of a major acceleration in economic growth. In fact, some data, including the downward revised fourth-quarter GNP and the December trade deficit, suggest the opposite.

(2) The underlying fundamentals which will determine the economy's performance in 1986 remain mixed. The slow growth in household incomes, the low saving rate, high household debt burdens, sluggish orders for capital goods, and high vacancy rates for many types of construction, are all somewhat negative. On the other hand, recent declines in interest rates, the dollar and oil prices, coupled with relatively lean inventories, are more favorable. However, even lower interest rates are necessary to produce much faster growth because interest rates in real terms, particularly for industrial companies, remain extremely high, and because of the restrictive impact of budget cuts in the short term. And the recent decline in the dollar has been insufficient to produce a sharp and early turnaround in the trade deficit. On balance, therefore, the economy will continue to grow at a modest rate on average, with neither a recession nor a major acceleration in economic growth very likely during 1986.

(3) Excluding any new policy actions, including any impact of the Gramm-Rudman-Hollings (GRH) balanced budget legislation, the Federal budget deficit will be approximately $210 billion in the current fiscal year, and close to $200 billion in FY 1987. In my judgment, GRH is flawed in several ways. In particular, it would cut the deficits too rapidly, causing too much of a depressing effect on the economy in the short term; it would not distinguish between efficient and inefficient programs; and it would cause excessively large cuts in defense and various nondefense programs because of the exclusion of over 60% of spending and the tax side. I believe that some tax increases are necessary to reduce future deficits — these should not reduce incentives for investment, should be targeted primarily toward those who are not now paying their fair share, and should not make the distribution of income and the tax burden less unequal than they are now.

(4) Both the Administration and the House tax reform proposals could weaken the economy during the first year after enactment, primarily reflecting the six month delay in the effective date for personal tax cuts (in both bills), the cutback in incentives for capital spending, and the reduced tax advantages for construction. The short-term shock effect will probably be somewhat greater if the Administration's proposal is enacted. Calculating the effects of tax reform in the long term is extremely difficult — nonetheless, it is likely that neither capital formation, productivity growth nor overall economic growth will be higher if either of the current comprehensive tax reform proposals are enacted than would otherwise occur.

(5) Economic growth could potentially accelerate more sharply in 1987 as the stimulative impact of declines in interest rates, the dollar and oil prices increases. However, extremely large deficit reduction and/or comprehensive tax reform could hold down growth in 1987, thus offsetting at least part of the stimulus from these factors.

(6) Current Administration forecasts of economic growth averaging 4% during the next two years are, thus, optimistic.

RECENT ECONOMIC PERFORMANCE

After the extremely strong growth experienced during the first six quarters of the current recovery, the nature of the recovery process has changed dramatically. In fact, during the last six quarters, economic growth has averaged only about 2%, not only far below the rate of growth earlier, but even well below long-term average growth in the United States. This slowdown occurred just when many were predicting that a continuing economic boom was in store, fueled by the tax cuts that were enacted in 1981. At the outset, it should be recognized that there was no economic boom in the first place. The problem stems from confusion between the direction and the level of economic activity -- while the economy was moving upward at a very rapid rate during the first half of 1984, economic activity was still considerably below its potential, reflecting the extremely weak conditions from which the recovery began. Thus, unemployment, capacity utilization, profits, and other important measures of economic performance were still far from satisfactory at that time, and in most cases, had not even returned to the relatively sluggish levels which existed in the 1970s. In fact, many industries and geographic areas were still extremely depressed, having experienced virtually no recovery at all.

Two other important aspects of the earlier stages of the economic recovery are also essential to help understand why rapid growth was so short-lived. First, the recovery was not caused by tax cuts alone; to a significant degree, what was in place was a cyclical rebound caused by a number of relatively transitory factors, such as inventory rebuilding in many industries, the large amount of pent-up demand for consumer durables and other goods that had previously built up, and an extremely loose monetary policy. The stimulative impact of these factors, as well as of the tax cuts and rising budget deficits, was bound to diminish in magnitude. Second, the faster-than-expected recovery during 1983 and early 1984 was simply using up idle resources more rapidly than had been anticipated, rather than reflecting any major improvement in the long-term growth potential of the U.S. economy.

In fact, the major sources of long-term growth have shown no fundamental improvement:

1. The growth in the labor force has slowed markedly since 1980, in part reflecting a slowdown in the rate of increase in the participation rate. This has occurred despite the reduction in marginal tax rates in recent years, which was supposed to have stimulated more work effort.

2. The rate of increase in productivity has been below the rate of increase during most previous recoveries. While productivity growth is exceeding its growth during much of the 1970s, the relatively modest rate of increase during the recovery thus far is somewhat disappointing in view of how rapidly GNP grew in its early stages, and in view of the emphasis on productivity enhancement and cost cutting. Most significantly, productivity growth has slowed sharply during the last several quarters, also suggesting that, at least at this point, the improvement in the underlying trend growth in productivity has been very modest at best.

3. Despite sharp cuts in marginal tax rates; the enactment of IRAs, Keoughs, and other direct savings incentives; extremely high nominal and real interest rates; and declining inflationary expectations, the personal saving rate during the last four years has averaged considerably less than in earlier years. Thus, even after adjusting for other factors which hold

down savings, it does not appear that there has been any increase in savings as a result of policy changes in recent years.

4. Profits as a share of GNP are still below the levels during much of the 1970s, although the quality of earnings has improved. Furthermore, profits weakened during 1985.

5. Despite the so called "investment boom," real net investment as a share of GNP has only recently returned to the levels which existed in earlier periods. Investment was extremely depressed in the early 1980s, so that the sharp increase in investment spending in 1983 and 1984 simply returned us to previous levels. In addition, a relatively large fraction of recent investment was for short-lived assets, many of which do not add significantly to capacity. Most significantly, there is no evidence that net investment relative to GNP is now, or will be, any higher than it has been historically, despite tax cuts and recently enacted investment incentives.

6. The U.S. competitive position in world markets has deteriorated dramatically in recent years.

7. Many industries, regions, and economic sectors have hardly participated in the recovery at all, indicating a high degree of imbalance and that the economy has not reached a fully prosperous and healthy condition.

So for all of these reasons, the rosy extrapolations regarding future growth were premature and dangerous to begin with -- the fact that economic growth has moderated thus comes as no surprise. What is highly disturbing, however, is the **degree** to which the pace of economic expansion has slowed. Growth over the last six quarters has not only lagged far behind the "New Era" expectations, but as mentioned earlier, it has even been considerably below the long-term average of the U.S. economy, even though the recovery is far from complete. In effect, interest rates and the U.S. dollar have been too high to permit more rapid economic growth and are thus the two principal factors which have presented a faster completion of the recovery process -- in turn, both have been primarily caused by high and rising Federal budget deficits at a point in the recovery when they should be falling sharply. Federal deficits became counterproductive for economic growth -- the direct stimulus of such deficits was outweighed by the adverse effects of the excessively high interest and dollar exchange rates which they have caused during the last eighteen months.

DECEMBER -- THE START OF SOMETHING BIG?

Despite the relatively low fourth-quarter increase in real GNP, the December economic statistics were considerably stronger than in previous months; however, it is premature to conclude that anything beyond a modest pickup has occurred. In particular:

1. Personal income grew by 1.4% in December, more than double the rate of increase during the prior several months, and almost triple the average increase during all of 1985. However, several temporary factors accounted for a substantial part of the gain: **(a)** Subsidy payments to farmers rose by more than $11 billion, causing total farm income to rise from $19 billion to $32 billion -- this will be reversed in coming months. **(b)** Interest income increased somewhat, reflecting some modest upward trend in interest rates which may not continue. **(c)** Of greatest significance was the sharp acceleration in wage and salary payments, from an average increase of about $10 billion during the prior four months to over $20 billion in December. The increase in part reflected a sharp rise in average wages -- however, this

increase does not appear to be consistent with other information. Furthermore, total payroll employment rose by 325,000 jobs in December -- this included a small pickup in manufacturing employment and another extremely large rise in services. This appears to be inconsistent with other labor market reports, such as the modest upward (although erratic) trend in initial claims for unemployment insurance. And a substantial part of the rise was in government payrolls, reflecting a nonrecurring salary adjustment for postal workers and an unsustainable gain in state and local government employment.

2. Consumer spending rose by a very large 2% in December, even more than the 1.9% rise in retail sales. However, these gains in part reflected a temporary increase in auto sales due to the implementation of a new round of below market interest rate promotions (which continued to bolster sales in January), as well as a big increase in expenditures for food due greatly to the temporary increase in meat and vegetable prices in recent months. Furthermore, total spending was influenced by an extremely large increase in expenditures for services, primarily for utilities and health care, which is unsustainable. Finally, the important department store sales component of retail activity has shown only modest strength in recent months, and early reports from various retail chains indicate a mixed pattern in January.

3. Housing starts jumped sharply in December -- however, the gain came from a very depressed level in November. This continues the erratic pattern that characterized housing starts during much of 1985, partly reflecting dramatic shifts in the weather (December was favorable for starting new construction; November was not), but with little upward trend. Furthermore, much of the gain during December was in multifamily construction, some of which was funded with tax-exempt industrial revenue bond financing prior to expected availability and regulatory constraints during 1986.

4. Industrial production rose by a strong 0.7% in December, following an upward revised 0.6% gain in November. These two increases represent the strongest performance for industrial production since mid-1984. However, the December production increase largely reflects the rise in manufacturing employment, and an increase in average hours, which are inconsistent with the National Association of Purchasing Managers' Index for December, as well as with reports from the National Federation of Independent Businesses. In addition, further gains in auto production such as the one in December are very unlikely -- in fact, some cutbacks will probably take place.

5. New orders for durable goods rose sharply (4.2%) in December; however, this follows some downward revisions in prior months. Furthermore, more than all of the increase resulted from several large orders for commercial aircraft which will not likely be repeated during the months ahead. Excluding commercial aircraft and military equipment, the trend for orders is still only modestly upward at best.

On balance, therefore, the December data appear to be unsustainable and overstate the strength of the economy, especially in view of the erratic nature of the monthly data -- thus, it is premature to conclude that a major acceleration in economic growth has begun. The January and February statistics will now take on great importance. If these data show further significant improvements, then the argument that a major pickup is in fact underway will have more credibility.

KEY ISSUES IN THE OUTLOOK

There are a number of key questions which will determine short-term economic performance, including the following:

1. Will the easing by the Fed during the past 15 months, and recent declines in long-term interest rates, finally generate more economic growth? There is almost universal agreement that the Federal Reserve has pursued a much more accommodative posture since late 1984 -- this is best indicated by the very sharp increase in the growth of nonborrowed reserves, as well as the relatively strong increase in the monetary base, since that time. Growth in the basic money supply has also been quite rapid -- in fact, the 12% annual rate of increase in M1 since September 1984 represents one of the longest periods of double-digit money supply growth in the entire postwar period. Despite this easing in monetary policy, however, the economy has grown very slowly, with only a modest pickup in economic growth at best now taking place. In my view, this reflects the likelihood that the stimulative impact of the recent strong growth in M1 is being overstated, for the following reasons.

A. Although interest rates have come down sharply, they remain extremely high in real terms. Thus, real short-term interest rates to finance inventories, real long-term rates to finance capital expenditures, and real mortgage rates to finance new home construction, are all still far above historical levels. Furthermore, real interest rates are now having a more restrictive effect than earlier in the recovery cycle, since a substantial portion of the pent-up demand for housing, durable goods and some types of business equipment that was created during earlier recessions has already been filled.

B. Although M1 has grown at a 12% annual rate over the last 15 months, the growth in M2 and M3 have been significantly lower. The growth in M1 has in part resulted from a shift into interest-bearing checking deposits from other instruments -- this shift has been caused by the downward trend in interest rates because of the reduced opportunity costs associated with these deposit forms. Recent difficulties among several non-Federally insured thrift institutions may also be causing some shifting of funds from thrift accounts to checkable deposits at large commercial banks, and thus into M1. In this context, it should be noted that the other checkable deposits component of M1 has accounted for much of the growth in M1. Thus, M1 may include a higher component of "savings" relative to transaction balances than has been the case in the past. The relationship between M1 and domestic economic performance has also been weakened by financial market deregulation and by the rapid growth in imports in recent years. As a result of these factors, M1 growth currently exaggerates the degree of monetary ease somewhat.

C. The effect of the Fed's easing is being significantly offset by a number of factors, most of which are highly unusual at this stage of the recovery: **(a)** Capacity utilization in manufacturing is both falling and relatively low -- operating rates have traditionally been over 85% (and rising) at this point in previous economic recoveries. **(b)** Vacancy rates among multifamily residences, office buildings, and commercial structures are also relatively high and rising -- this will soon depress new construction, even with lower interest rates. **(c)** Inventory liquidation, such as has been occurring in recent months, is also unusual at this point in the recovery. In fact, the third and fourth year of recoveries have historically been characterized by large inventory accumulation, which has frequently sown the seeds of the next recession. **(d)** The loss of high-paying manufacturing jobs, and the scaling back of wage increases throughout the economy in response to weak profits, have caused a dramatic deceleration in income growth -- this again is highly unusual at this stage of the recovery. This slowdown in income growth is especially troublesome because household debt has increased significantly

during the last year and because the saving rate is relatively low. (e) While declining mortgage rates do stimulate single-family home construction (each 1% decline in mortgage rates will increase single-family starts by 125,000), the slowdown in employment and income growth represents a major offset. Furthermore, minimum downpayment and income standards for the issuance of new mortgages are being tightened -- this will further limit the only modest pickup in housing that had previously been expected.

Thus, lower interest rates are needed just to keep the economy in the same place at this stage of the recovery; unless rates drop even further, the stimulative impacts will be relatively modest.

There has been much speculation in recent months about the likelihood of an additional easing move by the Federal Reserve, either in the form of a reduction in the discount rate or an increased supply of reserves (or both), designed to drive short-term interest rates lower. While the relatively strong December statistics have probably delayed such a move, I believe it is likely by early spring, for the following reasons:

A. The recent G-5 meeting in London appears to have been designed primarily to increase pressure on the Fed (both from the U.S. Treasury and from other governments and central banks) to lower U.S. interest rates as a step toward bringing interest rates down throughout the industrialized world. And, without some declines in short-term rates, there is a strong chance that long-term rates will back up further.

B. Continued declines in oil prices will have a favorable effect on inflation and inflationary expectations. The decline in oil prices will also intensify the debt problems of Mexico, Venezuela and some of the other lesser developed countries. Lower interest rates can be at least a partial offset.

C. While the December numbers were strong, real GNP growth in the fourth quarter was a disappointing 2.4%.

D. The very rapid (and well above target) growth in the basic money supply in 1985 is losing relevance because new targets will be put in place for 1986 -- furthermore, the money supply has slowed in recent weeks.

E. While the dollar continues to move in a downward direction, the decline has been very orderly and gradual. Thus, some modest additional reductions in short-term interest rates in the United States, especially if they are accompanied by comparable declines elsewhere, would not likely cause the dollar to fall precipitously.

F. Fiscal policy will become increasingly restrictive.

While these and other factors point to some modest easing, the Fed is likely to wait at least a month or two to determine whether the economy is already picking up enough speed to make further easing unnecessary. In addition, while oil prices are declining, prices of several other commodities (particularly gold, copper and aluminum) have strengthened in recent weeks, average hourly earnings rose significantly in December, and both the producer and consumer price indexes have risen more rapidly in recent months. Thus, Fed policy will likely remain unchanged until after the January and February economic and inflation statistics become available. If both moderate, as I expect, some additional easing would be in order and would likely occur by March or April, bringing rates down another 50 basis points from current levels.

60-987 O - 86 - 3

2. Will the near 25% decline in the dollar produce a sharp reduction in the U.S. trade deficit? The recent decline in the value of the U.S. dollar on foreign exchange markets has raised hopes of an early turnaround in the U.S. trade deficit. However, I believe such an expectation is premature -- as evidenced by the December data, the trade deficit will remain extremely high at least during early 1986 in response to the strengthening of the dollar which occurred during 1984 and early 1985. While price increases for some imported products have recently occurred, they have nonetheless been relatively limited. This reflects the fact that the dollar is now only marginally below its level in mid-1984 -- the increase in the value of the dollar in late 1984 and early 1985 is not relevant because it had little or no effect on relative prices and on trade patterns. Thus, the main impact of the decline of the dollar on foreign exchange markets thus far has been to reduce the extraordinary high profit margins of foreign companies who sell in U.S. markets (and/or their distributors). Furthermore, it will take considerable time before any price increases begin to reduce the demand for imported products in the United States, and export orders are still very weak. And, while the declining dollar has led to some delays or cancellations of additional plans of many U.S. companies to shift more of their production overseas (which should prevent the trade deficit from worsening in the future), there is no evidence that previous outsourcing is being reversed -- in fact, the full impact of those actions has not yet even been fully reflected in trade patterns. Thus, the trade deficit will probably remain close to current levels for several more quarters before a major improvement develops.

3. Will declining oil prices be a major stimulant for economic activity? The most significant nonpolicy development during the last month has been the dramatic decline in spot market oil prices to below $20 per barrel. Current spot prices are now approximately $7 per barrel lower than current contract prices for comparable grade crudes. The decline in spot prices essentially reflects three factors. **First,** Saudi production has increased significantly in recent weeks (to over 5 MBD), much of which is being sold through netback arrangements -- the Saudis were producing at a level as low as 2 MBD to 2.5 MBD during much of 1985. When coupled with still relatively high production levels in other OPEC countries, this has increased total OPEC output to the 18 MBD range, more than 2 MBD above sustainable world requirements. **Second,** it appears to be consistent with recent statements by various OPEC members that they will attempt to rebuild their share of oil markets, following the decline from approximately 60% to close to 30% during the last several years. Thus, the decline in spot prices reflects the effects of both higher actual, as well as anticipated, production by many OPEC members. Finally, the weather has been relatively mild throughout most of the United States and a good part of Europe during the current heating oil season -- weather forecasts are indicating a continuation of somewhat milder than normal weather both here and in Europe. This is intensifying already relatively weak demand for oil. The sharp declines in oil demand have at best only stabilized, and no increases are in sight.

The key question is whether the Saudis are deliberately driving prices down in order to create pressure on other OPEC countries, and on selected non-OPEC producers (especially the United Kingdom and Norway) to agree to new production cuts. At this point, it is unknown whether in fact that is the motive behind recent Saudi actions, and if so, whether it will be successful. My best judgment is that prices will stabilize at the current $18 to $20/b range, although there remains a very high risk that prices may continue to plumett, even to as low as $10 to $12/b, in view of the enormous excess capacity that exists in oil markets, and the prospect for flat worldwide demand at best. A significant rebound in oil prices is unlikely for at least the next three years, because the short-term price elasticity of demand is so low that it will take at least that long for demand to rise sufficiently enough, relative to potential supply, to exert any upward pressure on prices.

The decline in prices which have already occurred have improved the economic and inflation outlook -- however, the magnitude on the effect on real growth, especially in the near term, should not be overstated, since: **(a)** it will take many months before contract prices fall to the level of current spot prices; **(b)** even after that takes place, shipping delays will further lengthen the time before effective oil prices fall to less than $20/b in the United States; and **(c)** there is some lag before declining prices will affect incomes and spending. Furthermore, the bulk of the economic impact comes from the decline in the price of imported oil, since the effects of comparable declines in domestic prices will partly be offset by cutbacks in energy exploration and other expenditures by energy producers. And, since each $5/b decline in import prices increases household purchasing power by only approximately $9 billion, the total stimulative impact will be fairly modest even after the full impact works its way through the system.

While the net effect of falling oil prices is favorable (although several industries and geographic areas will be adversely affected), any further sharp price declines may actually be counterproductive, since they will aggravate the debt problems of many LDCs (especially Mexico) and will add to the strains which already exist in the financial system. Finally, as will be discussed later, I expect a significant portion of the decline to be offset by the imposition of an energy tax in the United States.

4. Will sharp reductions in the Federal budget deficit in accordance with the Gramm-Rudman-Hollings legislation have a major depressing effect on economic activity? It is becoming increasingly apparent that the Gramm-Rudman-Hollings (GRH) legislation could potentially have very dramatic negative effects on economic activity and on the effectiveness of numerous government programs, especially in 1987 and beyond. In great part, this reflects the fact that the baseline (or no action) deficit remains extremely high, even in comparison to previous relatively pessimistic Chase Econometrics estimates. Thus, it appears that the deficit will be in the range of $210 billion in the current fiscal yar, and near $200 billion in FY 1987, without any policy changes. This is far worse than Congress believed when GRH was enacted last fall -- thus, instead of having to close an expected $20 to $30 billion gap in order to achieve the $144 billion GRH mandated deficit target for FY 1987, a gap of near $60 billion will have to be closed. This would have to be accomplished either by the adoption of a budget which would include some combination of designated spending cuts and/or tax increases that would achieve the target, or by the automatic spending cuts spelled out in GRH.

In my view, the GRH triggering mechanism should not be allowed to take place in FY 1987, since the near $30 billion of cuts in national defense could jeopardize our military readiness, and since automatic cuts of the magnitude required would also create severe problems for mail delivery, for processing of tax returns, for air traffic safety, and for numerous other government programs and activities. In addition, several other problems with GRH have begun to surface. **First,** GRH does not distinguish between good programs and bad programs, ineffeciently run programs or well run programs, etc. **Second,** automatic cuts of the size necessary would cause significant declines in revenue sharing and various grant programs to state and local governments -- this would have to be offset by substantial spending cuts or tax increases by these governments. **Third,** there is some chance that the legislation will be found unconstitutional. **Fourth,** there are already signs of possible requests for supplemental appropriations to get around, or to offset, some of the cuts that GRH would require during 1986 -- this is bound to become more widespread in 1987 and beyond if GRH is triggered.

Perhaps most importantly, spending cuts and/or tax increases needed to reach the GRH target would have a severely depressing effect on an economy that is already likely to be growing only slowly at best when FY 1987 begins. The basic problem is that reaching a balanced

budget in 1991, given the current size of the deficit and the state of the economy, would exert too much of a negative drag on the economy. A better approach would have been to aim for a $50 to $75 billion deficit target by 1991, and for a balanced budget about two years later. While interest rates (and the dollar exchange rate) would likely decline significantly if GRH-sized deficit reduction were to take place later this year, the direct effects of the very restrictive fiscal policy would dominate in the short term, producing a sharp restrictive drag on the economy (especially in view of the likely reluctance of households and businesses to add to their already high debt levels, even if interest rates are lower).

My judgment is that for these reasons and others, some way should be found to raise the FY 1987 deficit target to $165 to $170 billion, or about one-half of the difference between the no-action deficit and the current GRH target. Both some modest defense and nondefense spending cuts, and some tax increases, will be needed to even reach this level. On the tax side, I would suggest an energy tax that would raise approximately $10 billion annually. This tax could be in the form of either a $5 per barrel tax on imported oil, or a ten cent per gallon tax on gasoline.

One last point concerning GRH -- if the law stands, 1987 will represent one of the few times when forecasts of the economy will have a major effect on the actual outcome, because they will at least in part determine the magnitude of spending cuts and/or tax increases, which in turn will in part determine actual economic performance. (The higher the forecast, the better the economy is likely to perform.)

5. How will enactment of comprehensive tax reform affect economic conditions? In view of the starting conditions, it is very likely that early enactment of the President's tax reform proposal, or the House bill, would have significant adverse effects on economic growth in the very short term. In particular, the elimination of the investment tax credit, reduced depreciation, and the windfall depreciation recapture (in the Administration proposal) would combine to significantly reduce the expected after-tax return on investment projects for many companies. On a net basis, these changes add up to a sizable increase in corporate taxes in the short term, even with the lower corporate tax rates provided for in the proposal. Given the already stagnant investment climate that has developed as a result of high interest rates, sluggish economic growth, and low and falling capacity utilization, investment would likely weaken further, especially since it would take years for many of the companies that will benefit from lower corporate tax rates to gear up their investment programs. Furthermore, without the current tax breaks, many of the construction projects that are now being considered, especially for office buildings, shopping centers, and apartment buildings, could not be justified. Vacancy rates are already extremely high for these types of strucutres, with relatively soft demand and declining rents in many areas. And it matters little for near-term economic activity and employment whether the construction projects and capital spending that are abandoned are "good projects" (that is, would have an acceptable return even without some of the current tax benefits), or are bad ones. Weakness in the economy in the short term could also result from the fact that both the Administration and House proposals would eliminate many personal deductions six months earlier than the reduction in personal tax rates -- many families would thus experience a tax increase for six months after enactment. (This also causes secondary effects on investment.) Thus, enactment of comprehensive tax reform effective during 1986, or 1/1/87, could slow the economy during much of 1987. The House tax proposal will have less of a short-term shock effect than the Administration's proposal, although it too would cause slower short-term growth. The adverse impacts on housing construction, tax shelters, and business construction would be reduced by the House bill, although construction of all types will be depressed, and equipment purchases will slow somewhat. Furthermore, as in the Administration case, a pickup in consumption will be delayed by the uneven timing of the proposal which results in actual tax increases for six months.

More specifically, an all at once major tax reform package (such as the two proposals now on the table) could have the following short-term effects on the economy:

A. Investment in business equipment will drop sharply from what would otherwise occur -- these declines in business investment would come primarily from reduced business cash flow, as well as from the indirect effects of slower overall economic growth.

B. Investment in business structures will drop even more sharply. Under the Administration plan, commercial and office building construction will be particularly hard hit because of various provisions which would sharply curtail tax sheltering through syndication. Under the House bill, the increase in the rental cost of capital for industrial structures would result in a sharper decline in construction of such structures -- commercial and office building construction will not fall as dramatically as under the Administration's proposal because tax sheltering will not be curtailed as much.

C. Multifamily housing construction will drop sharply (up to one-third) under the Administration's proposal because of the virtual elimination of tax syndications as well as a sharp cutback in tax exempt industrial revenue bond financing. Multifamily construction would also decline it the House proposal were enacted, but by a smaller amount.

D. The personal tax cuts under both proposals will bolster disposable income in the short run -- under the Administration's proposal, however, this would be almost completely offset by reduced income associated with weaker economic activity.

E. The net effect of these changes would be to reduce GNP by about 1% in the first year if the Administration's proposal is enacted, with a much smaller, but still negative effect, if the House proposal were implemented.

The likely adverse short-term effect on investment of both tax reform proposals could turn our to be even be larger than currently expected, in part because faster deficit reduction (if it occurred) would weaken the economy more sharply, and in part because of the enormous accumulation of debt by the corporate sector in recent years. Much of this debt has resulted from a substitution of debt for equity resulting from leveraged buyouts, corporate stock buybacks, mergers and acquisitions. The reduction in cash flow which will result from large corporate tax increases during the next several years if either current tax reform proposal is enacted will make this debt increasingly difficult to service, possibly resulting in sharper declines in business investment.

ECONOMIC OUTLOOK

Tables 1 and **2** and **Figure 1** indicate the assumptions underlying the current Chase Econometrics forecast, and projections for the key economic indicators for 1986 and 1987. As indicated the forecast is based on the assumption of additional declines in both interest rates and the dollar during 1986 and on only modest deficit reduction in 1987. The forecast also assumes enactment of a phased-in tax reform program starting in 1987, but with fairly small transition effects. Finally, a $10 billion energy tax increase is assumed.

Table 1
Major Forecast Assumptions

1.	Tax Increases (billion $)	1986	1987
	Personal Taxes	0	0
	Corporate Taxes	0	0
	Excise Taxes *	+5	+5
2.a	Federal Expenditures (billion $)	1986	1987
	Defense	281.1	290.5
	Nondefense	87.4	88.6
	Interest	139.3	149.3
2.b	Federal Expenditures (% change)	1986	1987
	Defense	7.3	3.3
	Nondefense	-4.9	1.4
	Interest	8.0	7.1

3. Three Month Treasury Bill Rates

1985	7.5
1986	6.7
1987	6.9

4. Food Price Increases (% Change)

1985	-0.5
1986	1.9
1987	2.5

5. U.S. Dollar (% Change)

1985	5.4
1986	-9.7
1987	-1.6

6. Oil Prices ($ Per Barrel)

1985	26.58
1986	20.50
1987	19.00

7. M1 Growth (% Change)

1985	8.9
1986	8.3
1987	6.6

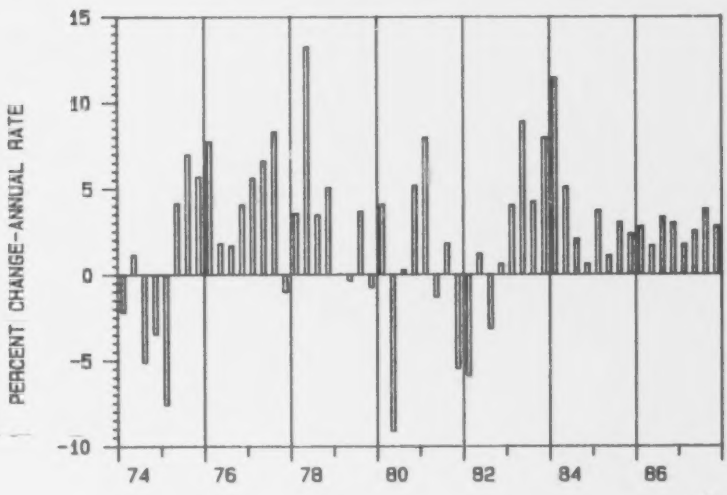
8. International Economic Growth: It is assumed that growth in other industrialized countries will accelerate somewhat, resulting from more fiscal stimulus and lower interest rates. Economic growth in the OECD countries other than the United States is expected to average between 2.5% and 3.0% per year during the forecast period.

* Assumes an energy tax increase of $10 billion per year implemented in July of 1986.

Table 2
Forecast Summary Table
(percent)

	1982	1983	1984	1985	1986	1987
Real GNP	-2.5	3.4	6.6	2.3	2.5	2.6
Industrial Production	-7.2	5.9	11.6	2.2	1.9	2.8
Real Consumption	1.3	4.6	4.4	3.2	2.6	2.8
Real Fixed Investment	-7.2	-1.8	19.5	9.7	3.4	3.3
Consumer Price Index	6.2	3.2	4.3	3.5	3.5	4.0
GNP Deflator	6.4	3.8	4.1	3.3	3.3	3.8
Pre-Tax Profits	-25.1	20.9	15.9	-4.5	3.5	-0.4
Unemployment Rate (%)	9.7	9.6	7.5	7.2	6.9	6.6
Prime Rate (%)	14.9	10.8	12.0	9.9	9.4	9.3
Auto Sales (million)	8.0	9.2	10.4	11.1	10.8	11.0
Housing Starts (mil.)	1.06	1.7	1.77	1.74	1.75	1.70

FIGURE 1
REAL GROSS NATIONAL PRODUCT



Outlook for 1986

The economy is likely to continue to be held back during much of 1986 by the extremely high real interest rates and overvalued dollar of recent years -- while both have been coming down, they remain too high to permit much more rapid growth. Furthermore, the lags associated with changes in interest rates and exchange rates are relatively long, so that the full impact of the declines already experienced, and those still to come, will not take place until the latter stages of 1986 at the earliest. As a result: **(a)** I expect interest-sensitive sectors, especially parts of construction, inventories, and capital spending, to remain fairly sluggish during 1986. **(b)** The trade deficit is unlikely to show any significant improvement during most of 1986 (although it will stop rising) because the decline in the dollar thus far has not yet been sufficient to alter relative competitiveness significantly.

In addition, other underlying forces remain relatively weak:

1. The outlook for consumer spending is for significantly slower growth than during 1985. The personal saving rate is low and fell again in December (even after adjusting for temporarily higher auto sales). Furthermore, while household debt burdens are beginning to grow more slowly, they nonetheless remain relatively high. And, most significantly, unless the December data starts a new trend, income growth will remain extremely sluggish in view of the wage and employment cutbacks in many industries and the shift in the employment mix to lower paying jobs. These forces will hold down the rise in consumer spending during much of 1986 -- partial offsets will come from the decline in oil prices, which will bolster purchasing power somewhat, the sharp increase in the value of household financial assets during the later stages of 1985, which will bolster household net worth, and still relatively good consumer confidence. It should be noted that the marginal propensity to consume out of household net worth is very low (in part because of the narrow concentration of ownership), so that even the near $500 billion increase in the value of household financial assets during 1985 will contribute no more than $10 to $15 billion to consumer spending during 1986. This is less than one-half of one percent of the current level of household expenditures. Thus, while no major retrenchment in consumer spending is in sight, strong growth in household spending is unlikely.

2. While profits appear to have bottomed out, any recovery is likely to be relatively slow, and concentrated in foreign earnings translations of multinationals.

3. Despite declining mortgage rates, total housing construction will not pick up significantly because of reduced pent-up demand among younger buyers, a declining rate of new household formation, tighter mortgage standards which financial institutions have adopted, and high vacancy rates for apartments and condominiums in many markets. Thus, a moderate rise in single family construction will be offset by declines in multi-family construction.

4. After surging earlier in the recovery, business investment has lost considerable steam, reflecting the following: **(a)** The surge in capital spending in 1983 and early 1984 came from an extremely low base, and thus in part was simply a makeup for extremely depressed spending during the prior several years. **(b)** The stimulative effect on the desired level of capital stock of investment incentives enacted in 1981 has in large part already been realized -- therefore, they will not continue to contribute to the growth in capital spending. **(c)** Capacity utilization is low in many industries as a result of weak demand and/or increased outsourcing. **(d)** The sharp decline in profits in the last several quarters has dramatically slowed cash flow. The slowdown in capital spending is highly evident from the recent pattern of nondefense capital goods orders (which have been flat since last summer), from recent plant and equipment surveys (which project little growth in 1986), from recent cutbacks in plant construction, and from signs that the commerical and office building construction boom of recent years is now beginning to taper off because of extremely high vacancy rates. It is thus clear that capital spending is not in a

position to lead to an acceleration in economic activity in the period ahead -- its outlook depends heavily on the general economic and profits outlook.

5. There is still no sign of any major widespread inventory rebuilding. In fact, inventory investment, excluding automobiles and farm products, rose at an annual rate of only $6 billion (1982 dollars) in the fourth quarter, not significantly above the levels of prior quarters. In addition, lead times are extremely low by historical standards and most industries are currently at relatively low operating rates -- this further diminishes the need for holding inventories. Thus, this is likely to be a neutral factor in the outlook for 1986.

6. The first round of budget cutting on March 1 will have a modest depressing effect on the economy later in 1986.

An outright recession in 1986 will probably be avoided. This reflects: **(a)** declining oil prices and generally low inflation, which will offset part of the effect of wage cutbacks on real incomes; **(b)** the likelihood that declines in interest rates and the dollar which have already occurred will prevent the economy from deteriorating, even though they might not be sufficient to generate much stronger growth; and **(c)** the absence of factors which frequently have caused recessions in the past, such as tight monetary policy, excessive inventories, or supply bottlenecks.

On a net basis, this averages out to economic growth of about 2.5% for 1986, somewhat above 1985, but still below the long-term average, and not sufficient to reduce already high unemployment or to lead to improved conditions in industries which are still very depressed. The mix will be quite different than in 1985, primarily reflecting slower growth in consumer spending, business investment, construction (except for single-family homes) and government spending, but without the depressing effect of additional inventory cutbacks or a further worsening of the trade deficit.

Outlook for 1987

In my judgment, the underlying fundamentals for economic growth will be stronger for 1987 than at anytime since mid-1984. This essentially reflects three factors: **(a)** Declines in interest rates will have a stronger impact in 1987, reflecting both the additional declines expected this year, and the lags associated with declines which have already occurred. **(b)** The potential for a significant turnaround in the trade deficit during 1987 is very high, especially if the dollar continues to decline during the months ahead as I expect. These declines will add to those already experienced and force additional price increases for many foreign products in U.S. markets, especially since foreign profit margins in the U.S. appear now to be reaching normal or even slightly below normal levels. By late 1986 and early 1987, most of the time lags associated with changing import and export patterns will also have been realized. Thus, the improvement in U.S. competitiveness in world markets, coupled with somewhat faster growth overseas, could cause both stronger exports and declining imports in 1987. This will not only contribute directly to production in the United States, but will generate significant multiplier effects by permitting profit margins to widen, and by reversing some of the losses of relatively high paying manufacturing jobs in recent years in the United States. **(c)** As mentioned earlier, the full impact of declining oil prices will not be experienced until later this year and 1987. Furthermore, I expect the household financial position to further improve during the course of 1986 for other reasons as well, including the likelihood of slow growth in household debt and more stability in the saving rate. These factors should lead to more buoyant consumer spending in 1987 in the absence of other policy changes.

As discussed earlier, it is possible that extremely large deficit reductions, combined with major tax reform, could offset the forces described above and prevent faster economic growth

from occurring, unless financial markets (and the Federal Reserve) anticipate the effects of deficit reduction far more and far earlier than seems likely. Deficit reduction necessary to achieve the GRH target for FY 1987 would hold down the economy, even though the long-term outlook would be strengthened, because the direct impact of fiscal policy changes will come much more quickly than the effects of additional declines in interest rates and/or the U.S. dollar that would result. This would reverse the pattern of recent years, when the enormous tax cuts and military spending increases which were adopted in the early 1980s (and which caused sharp increases in structural budget deficits) pushed the economy up rapidly during 1983 and early 1984 until the impact of the resulting higher real interest rates and overvalued dollar became more dominant.

Thus, the outlook for 1987 will depend heavily on the outcome of fiscal policy issues this year. With only modest deficit reduction and with either no tax reform or a phased-in program that would not slow the economy in the short term, economic growth will accelerate to the 3.5% to 4% range during 1987. However, allowing for substantial deficit reduction and the enactment of a tax reform measure which would be somewhat restrictive in the short term, my forecast is for economic growth to be in the 2.5% to 3% range, or only slightly above the expected rate of growth for 1986. It should be noted that even an earlier and sharper easing of monetary policy than I now expect would not fully offset the negative effects of sharp budget cutting in the current economic setting, because of the already high debt levels that currently exist; because of other factors which will dampen particular interest-sensitive sectors (e.g. overbuilding of many segments of consctruction); and because of the long lags associated with declines in interest rates. On balance, while declines in interest rates and the dollar that have already been experienced, plus additional declines I expect, as well as the full impact of declining oil prices, should stimulate stronger economic growth in 1987, it is likely that restrictive fiscal policies will limit economic growth to between 2.5% and 3.0%.

FORECAST RISKS

The major 1986 forecast risks relate to the consumer and to oil prices. On the plus side, somewhat further declines in oil prices would be even more stimulative than our current forecast assumes. It should be noted that if oil prices collapse (for example, fall to the very low teens), the negative effects associated with declining oil prices may start to become so severe as to exert a negative drag on the economy. The combination of lower oil prices and booming financial markets could generate more spending by consumers than we now expect, causing faster growth. On the downside, current strains in the financial system could worsen in 1986 — this, coupled with any other factor that would erode consumer confidence, could cause a significant household retrenchment.

The major risks for 1987 are primarily on the policy side. As discussed earlier, spending cuts and/or tax increases which would achieve the current Gramm-Rudman-Hollings target would exert a negative drag on the economy; this is likely even if the Fed eases somewhat in advance of those cuts because of the long lag before shifts in monetary policy affect the economy; and because at this stage of the recovery cycle, declining interest rates have less of a stimulative impact than they had earlier. Furthermore, enactment of comprehensive tax reform could negatively impact the economy in 1987, depending upon the specific tax changes incorporated in the legislation, and whether the changes are phased-in over time.

INFLATION

There is some concern, despite declining oil prices, that a significant pickup in inflation is on the horizon. This is in part due to the fact that the inflation statistics have worsened

somewhat during the last two months -- both the producer and consumer price indexes increased more rapidly during November and December than in previous months. In addition, the prices of many commodities, particularly gold, aluminum and copper, have risen substantially. However, much of the increase in the more broad based price indexes (including the fourth-quarter GNP price deflator) were caused by temporary increases in food and energy prices. The rise in food prices primarily reflected an increase in the prices of vegetables, reflecting weather problems in some growing areas, and higher meat prices, caused by a temporary decline in supplies. Heating oil and other oil product price increases in the later stages of 1985 occurred primarily because of low inventories. These forces are temporary, and in fact, are already in the process of being reversed. Furthermore, while some of the increases in commodity prices can be attributed to declining interest rates and declines in the value of the dollar, the rise in commodity prices has been fairly modest, has come from extremely depressed levels, and is being largely offset by the decline in oil prices. Perhaps most importantly, both the United States and world economies continue to be characterized by massive excess capacity in most industries, and by enormous oversupplies of most commodities. Unemployment also remains high on a worldwide basis, with no evidence of any significant labor shortages or related bottlenecks. Thus, while the decline in the value of the dollar will eventually exert some upward pressure on U.S. inflation, the other factors noted above will offset this impact, so that only a marginal acceleration in the inflation rate will occur during the next two years.

Representative OBEY. All right. Descending down the alphabet, Mr. Greenspan.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Mr. GREENSPAN. I have some mild differences with Larry Chimerine on the short-term economic outlook and some significant differences on the question of the desirability of implementing large deficit cuts and its impact on the economy.

As he pointed out, the leadtimes on the deliveries of materials, capital equipment and the like, are exceptionally short. We have, in effect, compressed the timeframe between delivery and order to about as low as it can get and perhaps as low as it's been in the post-World War II period. What that means is that for the first time that I recall, we have an economy which is working almost on a hand-to-mouth basis, including capital equipment. That suggests that the economic activity levels for the latter parts of 1986 are not on the books, and that will be determined to a very substantial extent by actions not yet taken.

The first quarter GNP numbers, as best we can judge, looking at the January data, are on the general track to match the administration's 4 percent real growth rate. We are obviously only halfway through the quarter and lots of things can go askew, but for the moment, I do not think one can argue that their growth path is falling short.

The problem, unfortunately, is that in order to continue that path through the rest of this year, we will have to begin to see a very significant pickup in new orders later this spring and into the summer months, because the pace at the moment is essentially inadequate to create the levels that are required. In fact, were it not for the extraordinary improvement in corporate profitability, which I think is emerging, and here I suspect I disagree somewhat with Larry Chimerine, as well as the marked increase in stock prices and the decline in long-term interest rates, it would be very difficult to imagine the type of growth which the administration is contemplating.

In any event, it is quite important to realize that it's essentially capital investment one way or the other which is going to drive the economy. At the moment, the average bookings for equipment are extraordinarily low, backlogs are low, and major equipment companies report very short leadtimes on the deliveries.

That means that there's got to be some considerable pickup coming as a consequence of the rise in stock prices and the fall in the cost of equity capital and the decline in long-term interest rates. But, oddly enough, the discussion of the economic forecast, whose purpose is to evaluate how to handle Gramm-Rudman really should be reversed, because how the issue of budget expectations evolves is going to be the major factor determining what actually will occur in the economy, so far as capital appropriations, orders and the like are concerned later this year and into 1987.

As best I can judge, the financial markets, after being exceptionally cynical about any retrenchment in the budget deficit, are beginning to sense, perhaps correctly, perhaps incorrectly, that there

may be something out there; that in effect, the emergence of Gramm-Rudman, and far more importantly, the reaction of the Congress, is different from what I think financial markets had assumed. That is creating a belief that somehow something of significance on the budget deficit is going to happen.

While I don't disagree with Larry Chimerine's view of what the current fiscal 1987 current services budget estimate should be, that's not what we're interested in. We're interested in how the CBO and OMB will actually evaluate the potential budget deficit in August of this year. What the budget deficit ultimately turns out to be or what a hard analysis of all its various options turns out to be is less important, in fact, of no importance, to what they think it will be at that point. That is obviously what is going to determine the extent of the budget expenditure reduction under the mandated law; presumably the guidelines which would create whatever compromise might specifically emerge.

The markets at this moment probably are assuming some significant reduction in the deficit. If surveys I've made are correct, money managers probably lowered long-term interest rates as a consequence, by anywhere from 1 to 1.5 percentage points.

If it turns out that Gramm-Rudman is declared unconstitutional and is not resurrectable, I suspect that the long-term interest rates will start back up, and we choke off all pending expansionary forces which are coming from the rising stock market and lower interest rates. We run into a significantly slower pace of economic activity later this year with a weakening, I would suspect, in 1987.

The problem then gets down to largely whether we can get long-term interest rates down, because unless we can, and unless we can get stock prices higher, I don't believe that we have enough in the way of capital investment in the economy to really make a difference.

It is certainly the case that current levels of capital investment as a percent of GNP are exceptionally high, but that in a way is not all that important, because the net investment, that is, the actual additions to the net property accounts from which productivity and growth come are quite subnormal or normal, depending on how one reads it. The reason, basically, is that we are producing shorter lived investments, which means that we depreciate them at a faster pace and that therefore, in order to get a specific level of net investment, we need a much higher level of gross investment. Gross investment is somewhat deceptive as a measure of productivity growth.

It is not deceptive, however, as an issue of employment-producing investment. Remember, investment does two things. It creates economic activity, and employment, whether it's productive or not, but the crucial question is, does it improve the productivity of the system?

The important question now is because the levels are so high on a gross basis, it is not easy to get investment continuing to grow, unless long-term interest rates come down appreciably more than they have, and I must say, I don't envisage that happening, unless Gramm-Rudman is actually in place, is functioning, and begins to bring down the overall budget deficit.

So the next tranche of budget expenditure reductions and/or receipt increases is very crucial to the levels of economic activity. What happens to Gramm-Rudman is more important to the economy than the other way around. At this moment, I would agree with what Larry is saying with respect to oil prices. I do believe we will get refinery acquisition costs of crude down to the spot market levels, which are in the area of $15.

That will bring down gasoline and petroleum product prices perhaps by 16 to 17 cents a gallon. For gasoline, at least, that will have a significant effect on the CPI. But that very fact is going to make it difficult politically to impose an oil tax. The presumption that you're going to impose an oil tax in some way that makes it politically easy, presumes that you could somehow insert the tax after the decline in crude oil prices but before product prices fall. But that cannot happen.

Even now, there's not enough time to do that. That means you're going to have several weeks to several months of low gasoline and home heating oil prices which consumers are going to perceive as they always do as right. You can not impose a marked 10-, 12-, 15-cent a gallon increase in gasoline prices easily. I think that would create far more difficulty than we know.

So in summary I think the economy is doing better at the moment than Larry Chimerine is saying. In the short run, our numbers are higher, and I think so far something in the area of 4 percent for the first quarter. Something close to that in the second quarter, seems to be occurring. The real problem rests in the longer term, and that is uncertain.

Finally, I say in my formal remarks that I don't believe that the Federal Reserve has to do anything in advance or even contemporaneously to offset the so-called fiscal drag of budget deficit reductions. If those reductions take place and are perceived to be credible, meaning that they will hit not only fiscal 1987, but 1988 and 1989, as well as, indeed, those types of programmatic cuts must do, then I think we get enough of a decline in inflation expectations, in inflation premiums and therefore, in long-term interest rates, a consequent significant rise in stock prices and a decline in cost of equity capital, and enough of an expansion in the interest-sensitive areas of the economy, to more than offset the fiscal drag which would occur as a consequence of a reduction in the deficit.

There is no credible reduction that Congress can make in conjunction with the administration in the deficit, which is contractionary. Whatever is even remotely politically feasible cannot, in my judgment, be large enough and quick enough to be contractionary. On the contrary, the markets will almost surely anticipate a real reduction sufficiently in advance to bring interest rates down and expand the interest-sensitive areas of the economy. Hence, I would not, as a consequence, be concerned about taking too much out of the budget deficit. Thank you.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN

The American economy is exhibiting modest signs of growth acceleration. GNP appears on a track through January which will produce a 4% growth rate for the first quarter. As has been true for some time, however, the economy has been running essentially in a hand-to-mouth fashion with very short lead times for deliveries of materials and supplies as well as capital equipment. As a consequence, inventories have been drawn down to levels which, in past years, would have created considerable concern on the part of production managers fearful of wildcat strikes or other shutdowns disrupting the exceptionally tight lines of supply. At the moment, however, import-conscious unions have been remarkably quiescent.

The short-term compression in economic decision making is particularly pronounced in the capital goods markets where backlogs for capital equipment remain quite low relative to shipments and appropriations backlogs for manufacturing corporations suggest very little in the way of longer term commitments. Only half of orders for equipment have promised delivery lead times of more than six months. This is an exceptionally low proportion for this category of durable good in which delivery times are typically fairly long. The dearth of forward commitments also shows up in planned capital expenditures where plans currently on the books, if one were to believe them, imply moderate increases in real outlays for the first six months of this year followed by significant declines.

In short, whatever is to materialize beyond the summer of 1986 is not foreshadowed yet by firm action generating decisions on the part of business management. Since there is very little currently on the books for the later part of 1986, a fairly significant acceleration in new orders and generally expansionary commitment trends must emerge relatively soon merely to assure the 4% annual rate of expansion projected by the Administration. Were it not for the significant improvement in corporate profitability, the decline in long-term interest rates, and the associated rise in stock prices, there would be little in the immediate outlook to suggest the type of acceleration in new orders and appropriations that are required to maintain the economy on the currently emerging growth path. The rise in stock prices, which is effectively an increase in the market's evaluation of existing capital facilities, raises the incentives to produce new capital equipment. More directly, reducing the cost of equity capital at any given prospective level of profitability for new facilities should cause capital appropriations to rise. The fall in oil prices will be a net positive benefit for the economy for 1987 and beyond, although the short-term impacts on the banking community are clearly negative.

*Dr. Alan Greenspan is President of Townsend-Greenspan & Co., Inc.

To a large extent, the uncertain prospects for capital investment and for the economy as a whole in the period beyond the fall of 1986 revolve around resolution of the budget difficulties and therefore the outlook for long-term interest rates and the cost of capital.

The financial markets are currently assuming, and hence discounting, some favorable resolution of the deficit problem. Should Gramm-Rudman-Hollings prove unconstitutional and be incapable of resurrection through constitutional means, long-term interest rates would rise by a point or more and undercut the improving growth path.

However, should the legality of Gramm-Rudman prevail, the tone of the economy by mid-August would allow OMB and CBO to assume for fiscal 1987 revenues which would imply a budget deficit of less than $190 billion. I am not saying that the deficit, excluding the sequesterings, would, after the fact, prove to be below $190 billion (I do doubt that), but merely that at the point of the determination of sequestering requirements for the fiscal 1987 budget, that the excess deficit, that is, the amounts over the statutory requirement of $144 billion -- would be below $50 billion. Such a sequestering requirement which, while severe, would not induce the panicky abandonment of deficit reduction endeavors that might be engendered by $60 billion or $70 billion required reductions.

This is important since an early success of Gramm-Rudman will reinforce the probability of success at each successive stage. This results from the fact that long-term interest rates (and stock prices by extension) remain excessively high owing to the fear that future deficits will require the creation of excess money growth by the Federal Reserve. The associated inflation expectations have become embodied in long-term interest rates as inflation premiums. To the extent that the markets begin to discount G-R-H's success and, hence, the expectation of lower deficits in the early 1990s, current inflation premiums built into long-term rates will fall, as indeed they have since the passage of Gramm-Rudman.

But that in turn raises the prospect of higher economic growth than currently contemplated and, hence, revenues, as well as reducing outlays tied to lower unemployment. The lower interest rates themselves make a difference. In fact, the decline in rates since the passage of Gramm-Rudman has significantly lowered expected fiscal 1987 interest payments on the federal debt and, hence, the deficit.

The concern that the so-called fiscal drag induced by the contemplated rapid decline in the deficit is misplaced. The type of deficit reduction program which would place us anywhere near the reduction path envisaged by G-R-H would be discounted well in advance by the financial markets. The effective demand which would be released by lower long-term interest rates and higher stock prices would surely outstrip the withdrawal of purchasing power contemplated by the reduction in fiscal stimulus. There is no more

likelihood of, say, a $100 billion deficit reduction over a two year period inducing a recession, than would its symmetrical equivalent, an increase in the deficit by that amount, create a sustained prosperity. There is no chance of overdoing deficit reduction in today's political environment. Any rate of deficit decline which is even remotely contractionary is not politically contemplatible. The argument which stipulates that the Fed must ease to accommodate any deficit reduction misreads how the markets would react.

At any given level of net borrowed reserves, or any other objective measure of Federal Reserve monetary posture, a projected favorable shift in the path of the deficit, would reduce today's inflation premiums and, hence, reduce long-term rates without action by the Fed. Arbitrage would immediately bring short-term rates down as well. I don't understand the current notion that the Fed must ease in advance of the reduction in the actual deficit or even to ease contemporaneously. In almost all credible scenarios, it is not only unnecessary, but may prove inflationary and, hence, counterproductive.

Obviously, I would not expect the Federal Reserve when confronted with increased credit demands as a consequence of lower interest rates so to restrict the growth in reserves as to inhibit any expansion. I would consider the usual partial accommodation of increasing credit demands during an expansionary period to be both proper and desirable. Either to anticipate credit demands or to go beyond moderate accommodation would, in my judgment, be a mistake.

Representative OBEY. Thank you. Mr. Thurow.

STATEMENT OF LESTER THUROW, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. THUROW. Well, in my younger days, I used to be an economic forecaster, but that's become big business, so I did something novel today. Actually got on a plane at 6:30 in the morning and came down to Washington and read the Economic Report of the President. I may be the only person, other than them that wrote it that read it.

And Chairman Sprinkel—as I was reading it for 4 hours, sitting in your offices this morning, Chairman Sprinkel is famous for the idea that private markets always do things better than public officials. And one of the President's initiatives this year is called "privatization." And after reading his forecast, I was going to suggest that we privatize forecasting and get Government officials out of the business of making economic forecasts, because the 4 percent growth rate may or may not be right, but I know you can't get it out of the Economic Report of the President, because the numbers simply almost in arithmetic terms don't add up.

And the page that this committee ought to focus on is page 60 of the Economic Report of the President.

There are a whole set of numbers there that just don't add. They don't add in several senses. The first sense is one that the chairman pointed out, and that is, there's this mysterious increase in productivity from minus 0.1 percent to 1.8 percent. The long run, trend rate growth of productivity over the last 7 years in the United States is 0.8 percent. And so they are assuming a doubling of the trend rate of growth of productivity. And the answer that was given this morning is that it was all cyclical upswing. We haven't had that kind of a productivity response to a modest increase in growth maybe ever, but certainly not in the last 20 years.

And so they are assuming basically that if you raise the growth rate from 2.5 percent to 4 percent, you raise the productivity growth rate from 0 to 2. And that has not been the experience in the American economy, I don't think ever, and certainly it hasn't been the experience in the last 20 years, because even a 10-percent rate of growth of output in 1983 only got a very modest increase in productivity of this order of magnitude, and so "sump'ins wrong" with the productivity numbers.

And the answer that was given to you an hour ago isn't correct.

Now if you look at the numbers above the productivity numbers, they are even more absurd. What those numbers say is that the rate of growth of the GNP is going to expand from 2.5 percent a year to 4 percent a year. And one of the arithmetic facts of life is, as the total gets bigger, each of the components have to get bigger or some of the components have to get bigger, but go down that list.

Personal consumption spending in 1985 rose 2.9 percent a year. Next year it's supposed to rise 2.6. None of the extra growth is coming out of consumption. Nonresidential fixed investment, last year it rose 6 percent. This year it is supposed to rise at 5 percent. So none of the increase in the economy comes out of investment.

Now residential investment is scheduled to go up from 6.4 percent to 8 percent. That's a relatively small amount, but there's something else wrong too, because if you look at the detailed data at the bottom of the table, it says housing starts are going to go from 1.7 to 1.9. That's an 11-percent increase in housing starts. And if you calculate the dollar magnitude up there a little higher in the table, that's a 25-percent increase.

So how does an 11-percent increase in housing starts become a 25-percent increase in expenditures? It only becomes that if you assume people are going to go out and build houses that are twice as expensive as the ones they've typically been building.

Then go to the next item. Federal purchases of goods and services. That's to fall by a whopping big amount. It was rising at 11.8 percent. It's supposed to fall at the rate of 4 percent a year.

Then we have State and local governments. According to this table, State and local governments are supposed to go up from 2.9 to 3.5, which is first of all, a modest increase, but second of all, because of the uncertainty of Gramm-Rudman and the diametral point that was made earlier in the day, that is a highly unlikely increase.

Last night I met with a group of Massachusetts local officials as to what they should do, given Gramm-Rudman, about their next year's budget, and the basic answer that all of them had as to what they were doing, was don't spend any extra money, because Congress may take it away from you.

Now even not making those changes, if you just take the numbers that add up there, and say, let's look at personal consumption expenditures, nonresidential fixed investment, residential investment, Federal purchases of goods and services and State and local purchases of goods and services. Take their numbers and ask what would happen to the economy if those numbers were the right numbers, the answer is, instead of growing at 2.5 percent a year, the economy would grow at 12.2 percent a year.

So all the numbers in this table show a slowdown in the economy, not a speedup in the economy.

Then the question, of course, is what numbers aren't in the table? And there are two numbers not in the table. The numbers not in the table in the GNP accounts are net exports and change in business inventories. You can do an arithmetic calculation and ask yourself how much would those two factors have to go up to make the components add to the total.

The answer is that those two factors would have to have a net increase. In other words, inventories would have to rise or exports would have to rise or imports would have to fall by $53 billion.

Now Mr. Sprinkel just told us verbally that he expects that the balance of trade deficit will be bigger, not smaller, and so what he's telling is that American industry is going to go out and buy something in excess of 60 billion dollars' worth of inventories, and that gets back to Mr. Greenspan's point and gets back to the point that leadtimes are very slow, and Larry's point that goods are not disappearing off the shelves. Why is anybody in American industry going to go out and buy 60 billion dollars' worth of inventories which is going to carry the entire economy, according to this forecast?

Now the other problem you've got here is, if you think about net exports, I agree with the chairman, basically, if there's an 18-month lag, then net exports today kind of correspond to where the currency was 18 months ago.

The interesting thing is the currency value today is just where it was 18 months ago. And so if you look at currency value, you shouldn't expect any improvement in net exports at all over the period of time that we're basically talking about.

And so what I think you've got here, unless somebody is pulling a rabbit out of a hat, the 4 percent may be right. The components that are listed in this table may be right, but they aren't consistent with each other, because there's no way you can take this detailed forecast that's presented here and get it up to the 4 percent growth rate that they talk about in terms of the overall target.

Now, there is one thing, interesting, that isn't even mentioned in the economic report because it must have happened after the economic report was written, and that's falling oil prices.

Now, if you think about falling oil prices making the forecast right, I think Larry's right, the magnitudes just aren't there to fill in the gap that the Council of Economic Advisers has to fill in.

The other problem that you really have to think about seriously if oil prices fall enough, and I think we're just about at that level, at some point, they create real hell in Oklahoma and Texas. And a big fraction of American economic growth has been occurring in the Southwest. And if you really put a damper on that in a major way, that's big enough to start having some impacts on the whole American economy.

It's not that the positives don't exceed the negatives, but the negatives are not trivial. You know, last year, we had 120 banks collapse in America. If you told me that 120 banks in Oklahoma next year were going to collapse, I would not regard that as outside the bounds of reality.

The famous Boone Pickens was in my office about a month ago trying to convince me about the robustness of his activities, and at that time, the price of oil was $23 to $24. And he convinced me that it was all very robust. He said:

> My God, even if the price of oil went down, it would have to go down to $15 before we'd be in trouble.

Well, where was it last night? Down at $15. I assume that means Boone Pickens is in trouble in that kind of an operation.

And so I think, you know, if you talk about privatization and forecasts, there's just something majorly wrong with this forecast—not necessarily that the 4 percent is wrong, but, technically, the pieces are put together in such a way that you can't get 4 percent out of it because nobody in their right mind can say that the whole American economy is going to fly on an inventory boom, and that's where the numbers have to point if you look at their detailed things.

And what Chairman Sprinkel said earlier, that he doesn't expect any improvement in the balance of trade.

Thank you.

Representative OBEY. Thank you all.

So, then, on the basis of what you said, let me ask all of you:

What do you think the degree of probability would be that we would, for the fiscal year in question, or for the year in question, get within one-half of 1 percent either side of the 4-percent projection that the administration is delivering to us today?

Mr. THUROW. Well, I'll tell you where I would put it. I think it would fall—it's 3 percent plus or minus one-half of 1 percent either way. You know, my Bayesian confidence on that is something like 70 percent.

Now one of the things you've got here is one of the absurdities of Gramm-Rudman, it really does have the fallacy of misplaced concreteness.

You're asking the CBO and the OMB to turn out numbers more accurate than they can possibly turn out—not just as forecasts, but as measurements. As we all know, we will measure the GNP for the next 12 months. Then, 6 months after 1986 is over, we will have a major revision.

And, often, that revision is more than 1 percentage point. Ten years later, when they do the final counts, they will have another revision. That's often 2 or 3 percentage points in any given year.

And so you're asking people not just to forecast numbers, but to measure numbers more accurately than it is possible to measure those numbers.

Now, that's why Alan's point is right. It doesn't make any difference what the real numbers are. The only thing that counts is what the CBO and OMB are going to say. And, of course, that's one of the ways to solve this problem:

Forecast booming growth. We all know it's crap, it isn't going to happen. But it solves the problem. What do you have to cut? Because the answer is: Not much. [Laughter.]

Representative OBEY. Well, it solves the problem for now, but it doesn't solve it come October because then the automatic sequesterer takes over.

Mr. CHIMERINE. Well, you can handle that by having CBO and OMB reach an agreement to forecast a recession in every year from now until 1991. If I may make a comment, Mr. Chairman, on your question. Without trying to narrow down these probabilities, I would agree with Lester that the probability of getting 4 percent growth this year is less than 50 percent, considerably less than 50 percent, I would say, although it's not out of the question.

But, it seems to me, you really have to worry about both years because, as we've all said, the amount that you have to cut next year will depend how much economic growth you have this year, which will determine the starting point. And, second, how much they're going to be predicting for 1987.

So the key question is: Can you reasonably expect to have 4 percent growth for the next 2 years, or an average of the 2 years?

And I would put that as very, very improbable.

Mr. GREENSPAN. I'm slightly more optimistic but then again, we're pressing these numbers far beyond our capacity to really understand.

I find myself on the one hand feeling uncomfortable with Beryl Sprinkel having unexceptionable confidence that his numbers are right within 0.2 or 0.3 percentage points. But I also feel uncomfortable with Larry Chimerine's assertion.

There's a much wider uncertainty out there than anybody is discussing. The odds that we will see a path of growth in the next 6 months or so, which will be close to the administration's forecast——

Mr. THUROW. But they can't come from the administration's forecast.

Mr. GREENSPAN. No, it's not coming from the administration's forecast. But that will create an atmosphere for the normal bias toward optimism in both the CBO and OMB. There is a political reason why there is a tendency for an upward bias in both groups.

They're going to create a deficit estimate which is going to be under $190 billion for fiscal 1987. And that, in turn, may actually create an ability on the part of the Congress to deal with something which, if it were a $60 to $70 billion cut requirement, would probably disintegrate the system.

The irony is that because the numbers are at least reachable, it may be a lot easier to do and, therefore, make the overall budget deficit reduction process easier for this first tranche.

But, if, as I think the three of us are saying, 4 percent may be plausible, it is not implausible for the next three, maybe even four quarters, which is what the administration is saying.

It's hard to project that much beyond the end of this year. And, as a consequence, when you readdress this issue in 1987 and go through the same procedures of snapshots in August 1987, for the fiscal 1988 budget, I think there's going to be some really very difficult problems. Something is going to give along the way but, so far, I think the assertion that somehow the administration's forecast is quite implausible for the current year, may or may not be true. But I think that it is clearly not off track at this particular moment.

Representative OBEY. Let me ask another question, and then turn it over to Congressman Scheuer.

I put a hypothetical to Mr. Sprinkel earlier, and I'd like to put a similar but not identical hypothetical to the three of you.

I don't know whether it's possible that the Congress would meet the President's exact budget proposals to the tee. I think everybody doubts that. I hope what we do is put it on the floor to find out so that we find out early whether that's a viable option or not.

My view has been, and I know that—at least, I get the impression, Mr. Greenspan, that you are dubious about that, too.

My view has been that the problem in this town is we all believe our own baloney and we perform accordingly. And on the Democratic side, the baloney is our entitlements position. And on the Republican, or on the administration side, I should say, not Republican, because Pete Domenici takes a different view, on the White House side, the baloney is that no revenues shall be required, or provided.

And so what I see happening is a 6-month impasse. Then we get close to October 1. We have a last minute panic compromise on the CR. And the Feds have no leadtime at all to figure out what the hell it is we're going to be doing before the fiscal year begins.

And what my instincts tell me would make sense is that if we could somehow cut through this, get to an early grand compromise, as has been described, which makes some quickly reasonable ac-

commodations on the deficit by reaching the combination of changes in defense, revenues, and domestic spending.

And my view has been the reason that would be important is because if we have to then go through—if we miss the forecast. If we delay and miss the forecast and have to do a double cut, the likelihood is that Congress isn't going to want to go through that second double cut before the election.

So then we get into the chaos of sequesterization. And then the other reason is that if we could reach an early agreement, the Feds would have a quicker understanding of what it is that is going to happen on the fiscal side——

Mr. GREENSPAN. The Federal Reserve, you say?

Representative OBEY. Yes; the Fed, I mean, not the Feds, and not the revenuers. [Laughter.]

That they would have a better idea of what we would be doing and would be able to make their decisions in a more orderly way as well.

And so I guess what I'd ask each of you is:

Is there really any importance in trying to cut through this 6 months Alphonse and Gaston routine that's going to go on here? And get to the bottom lines without the usual baloney?

Is there? Is it important that we do that? Or isn't it? And shouldn't we be disturbed if we go through another round of business as usual on everybody stating first preferences before we get to the final point?

Mr. GREENSPAN. It's important, Mr. Chairman, but not because of the Federal Reserve. It's important because we have this view that as soon as everybody decides that they want to have a grand compromise, that it therefore is mechanically simple to go ahead and implement it.

That might be the case if you were negotiating something rather simple in which you can split the differences. But this is a very complex compromise.

I can clearly envisage all of the key parties involved being enthusiastic about the issue of compromise and being unable to do so. In other words, it does not automatically follow that the desire to have a grand compromise creates one.

That's especially true when you realize how complex these sets of alternate choices are. We are looking at various permutations and combinations of different forms of solutions to this, which are mindboggling.

It is quite conceivable that we may not have a majority vote in both Houses; one which the President would acquiesce in on any single solution, even though everyone has their own solution.

Therefore, the endeavor to wait until the last minute almost surely increases the odds of failure. The sooner that you start, the more likely that somebody is going to find some mechanism that works. There's no immediate one that comes to mind, for which there is a majority in either House at this particular moment.

I'm not concerned about the Federal Reserve because, as I say in my formal remarks, the mere fact of the Congress actually reducing the deficit prospective through the latter part of the 1980's and into the early 1990's will bring down interest rates immediately.

The financial community will move far more rapidly than the Congress could conceivably. And even were it required for the Federal Reserve to take action as a consequence, it, too, can move instantaneously.

There is no timeframe. There is no judgmental issue that has to be resolved there. The crucial question is finding a mechanism which can actually work on the issue of compromise with the Congress and the administration.

The Federal Reserve in this particular endeavor is really not a relevant institution.

Mr. CHIMERINE. Mr. Chairman, I would agree with Alan. I think there are three reasons why you ought to do it as quickly as you can.

One is because it's going to be very, very difficult to do. The longer you wait, the closer you're going to get to the Gramm-Rudman deadline.

And I think the market has become very skeptical because the markets believe that the Congress and the administration would not allow the automatic sequesterization process to go into effect in fiscal 1987, particularly because the administration would not permit $25 to $30 billion in Defense cuts.

And, as a result, the longer this process goes on, the more likely the markets will start to back up. So the first reason is the time it takes. The second one is that you not only won't get the financial market benefits early enough if you wait too long, but you could have the reverse effect. To the extent that some of this has been discounted, the markets could actually back up.

And, third, I would disagree with Alan on the Fed. I think it is important for the Fed to ease. Quite frankly, I think the Fed should ease regardless of what happens to Gramm-Rudman. And the sooner they have confidence that sizable deficit reduction will occur, the earlier they can consider loosening.

So, it is important to do it as quickly as you can for those three reasons.

Mr. THUROW. I guess I would agree with that. The other thing, you see, I think Alan is being a little bit optimistic about—let's even grant his premise, that if you had a compromise, interest rates would come down.

Given all the excess capacity sitting out there in the American market and in the world market, it isn't a question whether interest rates would come down. It's a question of how fast will the industrial sector respond to lower interest rates.

And I think there's no question that Alan's right, that maybe interest rates might come down rapidly. There's a lot of question as to what that response will be, because, here, you get into this question about consumer debt. And, you know, they've leveraged themselves very highly. Are they going to do it more even if interest rates come down?

And, of course, at some point, if you really get the proposition that interest rates are coming down, you say, hey, let's wait until they're lower before I buy the house, buy the car. And you get people postponing purchases as opposed to making purchases the minute interest rates start to fall a little bit.

The other thing I think that's relevant in the long run about Gramm-Rudman, if you think of the Fed's capacity or the market's capacity to offset fiscal tightness with lower interest rates, in the long run, if you were really going to do Gramm-Rudman and in 1991 have a balanced budget, the honest fact of the matter, to do that technically, without causing a worldwide recession, you need the cooperation of the German and the Japanese Governments; because they've got to be stimulating their economies at the same time.

If you think of a—you see, I think the right number, if you're thinking about 1991, how much either expenditure cuts or revenue increases you've got to have, the $200 billion is more right than the 180.

And if you think it takes a million people working 1 year to produce 40 billion dollars' worth of goods and services in the American economy, that means $200 billion represents 5 million jobs.

And if you just raise taxes quickly, or cut spending quickly, you'd take 5 million jobs out of the system. And I don't know any way the Fed can offset 5 million jobs. I think the Fed, plus Germany, plus Japan can offset 5 million jobs.

But I don't think there's anything that the markets or the Federal Reserve Board can do to offset that kind of massive shift in fiscal policy, because we've built a whole economy—and by this, I mean world economy, not just American economy—that depends for its engine of growth on that big American fiscal deficit.

And if we just get rid of it and don't do anything else, both here and other places in the world, we simply produce a recession. We don't solve the problem.

Mr. GREENSPAN. I don't want to prolong this but I just want to say I really disagree with that.

Mr. CHIMERINE. I'm closer to the mike, Alan, so I'm going to go first.

I guess I have a disagreement with both Lester and Alan and it's a matter of differentiating between the short-term effects and the long-term effects.

I feel very strongly that if you get deficits on a downward path, the benefits through much lower interest rates and conceivably a much lower dollar probably will begin to offset the loss of fiscal stimulus. It will be a much more balanced economy, a less risky economy. However, it should not be done too quickly—I think balancing the budget by 1991, quite frankly, is too fast. I'd like to see a $25 to $30 billion a year reduction from the prior year, which means a $50 to $75 billion debt in 1991 instead of zero.

Where I disagree with Alan is the short term. If you cut $50 to $60 billion in 1 year, even if the Fed does respond in advance by easing, but certainly, if they don't, I don't see how you can possibly avoid some slowdown in the economy for at least a year or two while you're cutting that much fiscal stimulus out of the system.

Mr. GREENSPAN. The real question is not so much in the consumer area, which I think would respond in part, but I grant you that the impact in the consumer area cannot be very large.

The crucial question is capital investment. The one thing we know reasonably well, if you look at the structure of corporate planning company by company, is that the inordinately high cost

of capital, both real and nominal, in recent years has created a major backing up of facilities replacement, which would move forward at a very dramatic pace in the event that there was a significant decline in the cost of capital.

Even though it takes a long period of time to go from appropriations, which would respond very quickly, to actual capital outlays, you nonetheless, as you track the process, can see very significant movements in inventory patterns which would emerge in advance of the capital investment.

You can simulate what would occur, bringing long-term rates, not back to where they used to be—remember, we used to sell long-term Treasury's at 2.5 percent, but merely bringing the long-term interest rates down 2 or 3 points. In a relatively short period of time, the effects of that could be extraordinarily expansionary. The presumption that you cannot overcome something as large as a $50 billion a year reduction in the budget deficit or something of that dimension, strikes me as significantly underestimating the extent of damage this high cost of capital has done to the replacement markets in the investment area in the last 5 or 6 years.

Mr. THUROW. Let me make just one brief comment on that because you have got a real problem here, and that is at the current value of the dollar nobody is going to run out and build American facilities because if you see something, a market that needs to be served, you do offshore production. That is the cheapest place to do it.

Now, if you assume the dollar is going to fall another 30 or 40 percent over the next couple of years, then you can start talking about a capital goods boom.

But we got an 80-percent capacity utilization rate——

Mr. GREENSPAN. I am talking wholly replacement. I didn't say a word about capacity.

Mr. THUROW. Well, but I think when it comes to replacing at the moment, you are going to replace American production with Taiwan production. You are not going to rebuild those American facilities.

Representative OBEY. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Our time is short, and we have a rollcall vote, followed by several 5-minute votes. So I don't think there is much disposition to come back.

I would ask you gentlemen, any of you who are interested, to answer in writing the questions that I pose to the Chairman of the Council, including the last question, with the implications that the question of that horrendous figure on page 77 of the Economic Report of the President that the low income countries in Africa have suffered a cumulative 8.7 average decline in real per capita income over the last 4 years and the implications of that to the administration's policy on family planning.

Now, I understand quite well that family planning is normally outside of the orbit of pure economists like yourselves. But this figure is so horrendous and the implications are so stark that if you have any thoughts on it I would appreciate it.

We have maybe 2 or 3 minutes, and if any of you would——

Mr. THUROW. That would mean only impure economists deal with family planning. [Laughter.]

Representative SCHEUER. If you would like to address, any of you would like to address briefly the questions of competitiveness and productiveness or the questions of our role as a productive actor in world commerce, I would enjoy hearing that, but I hope that you will take the occasion to answer the questions that we will submit in writing.

Mr. GREENSPAN. I don't know of any economist who can talk for less than 2 minutes. [Laughter.]

Mr. THUROW. We will go home.

Representative OBEY. Let me ask just one last question because Jim's assessment of what is happening on the floor is right.

When the Fed meets next week, what do you think their target ought to be in terms of M1 for next year?

Mr. THUROW. I think they ought not to have an M1 target. I think they ought to be looking at interest rates and ask yourself the question where do interest rates have to be to keep the economy ticking over at a reasonable level, and anything they can do to help get the economy to your 4-percent growth rate, in my estimation, is a positive because I don't think it is going to be there without some active help on the part of the Fed between now and January 1987.

Mr. CHIMERINE. I would agree, although I guess they are committed to targets. I would urge them to keep them as wide as possible—particularly for M1—because some of the factors that have been pushing up M1 very rapidly may continue to do so. I think that has been exaggerating the degree of monetary ease.

So I would strongly support a range of 4 to 10 percent, or something like that. In other words, very wide band, giving them a lot of flexibility.

And one other point, Mr. Chairman. I thought I heard Chairman Sprinkel say that he would urge the Fed to start to slow the growth of reserves and tighten up.

Mr. THUROW. That is what he says in here.

Mr. CHIMERINE. I must live in a different world. I don't understand that at all.

If they tighten now on top of these budget cuts, we will have a significant slowdown, if not a recession, by 1987.

Mr. GREENSPAN. The Federal Reserve is going to have some difficulties over the next 2 or 3 years in having to supply reserves to the system because of financial difficulties of major institutions. As far as I am concerned, it is probably wise for them to keep their powder dry, so to speak. Significant expansions of credit, whether it be M1, monetary reserves, or any of the other M's or credit bases, probably should be kept restrained at this stage because we will end up after the fact with perhaps more credit extensions than I think we would need.

Representative OBEY. Gentlemen, thank you all.

I would just like to make one statement in response to something you said, Mr. Greenspan.

I agree that it is sort of backward to look the way we are looking at economic projections in terms of trying to determine what is going to happen in the budget process and that it makes more

sense probably to look at things in the reverse order, except for one—but you then went on to say that—well, I have forgotten frankly how you put it, but what I thought you said was that it was not all that important to Gramm-Rudman what the economic numbers turned out to be.

Mr. GREENSPAN. Yes.

Representative OBEY. I agree with that economically.

The problem is that in terms of the chaos that it creates in terms of congressional budgeting, it is just mindboggling because, as Les says, I don't believe anybody can predict to the degree that you are supposed to be accurate under Gramm-Rudman, and that means that we are going to—instead of having four budget cycles we have to go through, which is authorization, budget resolution, appropriation, and continuing, we are now going to have five.

We are going to decide what happens in an authorization, then on the budget resolution, then on appropriation, then on reconciliation, then on continuing, and then on another shot at the budget numbers before we get to a continuing.

And if the President thinks that the budget process is broke now under these circumstances, I invite him to wait until October 1 and see what he thinks of the new process because it is going to consume all our time and all our energy and we won't be able to look at anything in terms of what the hell else we need besides hitting the specific number on the balance sheet to make this economy competitive. Well, I thank you all.

The committee stands recessed.

[Whereupon, at 2:55 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 20, 1986.]

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. BERYL W. SPRINKEL TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE SCHEUER

Question 1: What would be your recommendation to the President, or what would be the policy of this Administration, on improving our productivity and improving our ability to compete as serious global actors in the world economy? This question has two additional parts:

Question 1.a.: How do we improve corporate decision-making? How do we encourage corporations to make the best use of the benefits and incentives that we already give them -- quotas, import restrictions, etc. -- to improve their ability to compete?

Answer: Rising productivity allows a rising U.S. standard of living, as the Nation produces greater output from the same inputs. Factors that contribute toward greater productivity include efforts by U.S. firms and workers to design new products, to develop new production processes, and to restructure their workplace operations more efficiently. The goal of the Administration is to ensure that Americans face the right incentives to undertake these efforts to become more productive.

A major disincentive to improved productivity is unreliable macroeconomic performance. High and variable inflation rates particularly can distort economic signals and discourage investment in productive resources. In the late 1970s and early 1980s, for example, investors became less willing to hold fixed rate financial assets and shifted funds into alternative assets such as gold and real estate. Not only did the initial purchasers of the fixed rate assets experience large losses, but the efforts of all investors to forecast volatile economic conditions and to shift their portfolios accordingly resulted in a less efficient allocation of resources. Correspondingly, when the inflationary excesses led to more contractionary policy, the decline in U.S. output and the emergence of excess capacity further reduced the incentive to consider productivity enhancing investments.

Unpredictable policy and uncertainty over future market conditions deter productive investment in other ways, too. Businesses and workers undertake new investments in research, capital equipment and training when they can predict a future payoff from such action. As future returns become less certain and more risky, actions which would enhance U.S. productivity are less likely. Therefore, a priority of the Administration is to pursue predictable policies that allow the attractiveness of alternative investments to be assessed on the basis of market returns. In contrast, when governments intervene to assist first one industry and then another, the economic basis for making investment decisions becomes blurred, and shifts in government policy become a major source of uncertainty.

Government policies to ensure stable macroeconomic performance and the efficient operation of markets are twin priorities in improving U.S. productivity and competitiveness. Related policy concerns are government rules and regulations that reduce our competitiveness internationally. One form of regulation, the restriction of imports, has been advocated by some for industries whose competitiveness internationally has fallen. Too often this protection prolongs the lack of adjustment in industries that have been unable to develop successful strategies to remain competitive. Requiring that additional funds be invested in protected industries is a misdirected policy if there are few prospects that new technologies or greater worker productivity will sufficiently improve competitiveness. The extra capacity created may simply add to the pressure to maintain protectionist policies. At the same time industries which use the protected inputs become less competitive and retaliation against U.S. exports may occur. Government measures to promote adjustment and long-run competitiveness of an industry have most appropriately focused on providing better information on which to base private investment decisions, with the recognition that trade relief will be eliminated over time and any new U.S. capacity must be competitive under such circumstances.

Question 1.b: How do we upgrade labor skills? What do we do about the monumental problem facing American productivity of adult illiteracy? Should we be using the corporation and the workplace to provide education? What specific programs and research is the Administration directing to the horrendous problem of adult illiteracy and upgrading of labor skills?

Answer: The Administration's economic policies are creating an environment in which individuals' and firms' investment in human capital can be enhanced. Incentives and opportunities for investment will lead to improved skills and productivity of the work force. The future competitiveness of the U.S. economy will also depend on the quality of new labor force entrants. These new workers must have mastery of basic skills that will enable them to participate effectively in private sector occupational training. New workers must also have job opportunities -- so that they may learn discipline and work habits as well as job-related skills.

The Administration has taken a number of initiatives to reduce the unacceptably high level of adult illiteracy. These include steps that will focus existing Federal programs on improving literacy, in part through better methods of teaching reading. The Administration's legislative initiatives will foster choice in public and private education through the use of tuition tax credits and expanded opportunities for educationally disadvantaged children.

Question 2: What kinds of incentives are needed to convince the American people to end their orgy of consumerism and direct more of their assets and net worth into productive investment?

Answer: Much so called consumerism consists of investment in consumer durables such as cars, appliances, etc. These capital investments are productive -- otherwise individuals would not have made them. It is also important to provide adequate incentives for business investment. The tax system is one way to provide

such incentives. Perhaps equally important is the need to avoid unnecessary and burdensome overregulation of the private sector. The incentive to invest is certainly diminished to the extent that firms fear that future regulation will limit the value of today's investments.

The tax system is currently a focus of our attention. The current House bill, while advantageous in many ways, does not go far enough in providing general investment incentives. However, the House bill does tend to level the playing field for different types of investment. This is important since uneven tax treatments of different types of capital reduce the overall productivity of the Nation's capital.

Question 3: In particular, how do we end the overinvestment in housing? How do we direct some of that investment, through tax benefits or other incentives, into the industrial sector, which is in fierce competition with tough, competent, and motivated competitors from abroad?

Answer: There is indeed some evidence that the tax system favors housing, although several recent studies indicate that the net favoritism is small. Because of this and because of the importance of housing to the American public, it would be unjustified to act too strongly to reduce investment in housing. For instance, eliminating the deductibility of interest payments would be a draconian measure that would cause considerable hardship. A much more appropriate strategy is to reduce only slightly the relative tax subsidy to housing that, as you note, encourages overinvestment in housing and underinvestment in industrial capacity. Eliminating the deductibility of property taxes, as the Administration has proposed, moves precisely in the direction of leveling the playing field so as to provide more industrial capacity and slightly less housing.

Question 4: Would you comment on a range of new taxes that have been mentioned, including an energy tax, a value-added tax, and the minimum tax on wealthy corporations and wealthy individuals in our country? What would be the economic effect of each of these taxes and how would they affect the middle class?

Answer: These new taxes are socially costly ways for our government to avoid fulfilling its responsibility to manage the public budget prudently. Any tax transfers resources from private citizens to the government. Energy taxes, oil-import fees, and value-added taxes would all raise prices to all consumers. These taxes would hurt economic growth, job formation, and the economic future of our country. There is no justification for increasing taxes to pay for excessive public spending or for the continuation of special tax loopholes.

An energy tax or an oil-import fee would be particularly unbalanced in their effects, seriously hurting energy-intensive industries, agriculture, and consumers in the northeast and midwest. A value-added tax would spread the pain more evenly, but would still cause significant total pain. Further, instituting a broad-based value-added tax (or business transfer tax, which is essentially the same thing) would be an invitation to future tax increases and to a corresponding lack of fiscal restraint in the future. Finally, minimum taxes do have a role to play in making sure that all pay some taxes, but this role should not be exaggerated. Ultimately, it is better to broaden the base of the regular tax and eliminate the sort of excessive preferences that make the minimum tax necessary. In any case, the minimum tax, imposed either on individuals or corporations, also distorts economic behavior and reduces the performance of the economy.

Question 5: Let me quote from page 77 of the Economic Report of the President:

> Low income countries in Africa suffered a cumulative 8.7 percent decline in average real per capita income over these four years (referring to 1980-1984).

60-987 0 - 86 - 4

Question 5 (Continued): Isn't the lesson of this horrifying figure that we have to intervene at least to give these countries a chance to get hold of themselves and create some kind of bootstrap operation by giving young couples in these countries a chance to moderate their fertility? Doesn't this figure justify a change in the Administration's position on our family planning aid overseas?

Answer: The recent acute problems of a number of African countries have been of great concern to the American people and to the Administration. The United States has played a leading role in efforts to feed starving people in Ethiopia and elsewhere in Sub-Saharan Africa. The United States has also provided more general assistance to the countries of Africa through bilateral aid and through its support of the World Bank.

In my view, the recent problems in a number of African countries do not justify a change in the Administration's policy on family planning and overseas aid. The problems of hunger and starvation recently experienced in a number of African countries are not primarily a consequence of rapid population growth, but rather of inadequate food production and distribution. In addition, bad weather has contributed to poor harvests, and governments in some countries have policies that have discouraged agricultural production.

THE 1986 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 20, 1986

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room 2167, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey, Scheuer, and Lungren; and Senators Mattingly and D'Amato.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative OBEY. The Joint Economic Committee is very pleased to welcome Treasury Secretary James Baker to testify before us this morning on the administration's economic policies and outlook for 1986.

Mr. Secretary, I want to say that I hope that the cold reception which the President's budget has received thus far from members of both political parties on Capitol Hill is not an indication that a new era of cooperation between the legislative and executive branches will not be attained in the coming months. Frankly, I think that a far higher level of cooperation is essential if we are to deal with our economic problems.

We have recently gotten several pieces of very good economic news that should make our underlying problems somewhat easier to solve. The retreat in oil prices has sent the Producer Price Index plummeting and promises to do the same with the Consumer Price Index. If the drop in oil prices holds, it ought to mean an additional $12 to $16 billion in the pockets of American consumers that could be spent for other things.

I believe that the 4-percent real growth forecast by the administration for the economy this year was highly improbable before we got lucky on oil prices, but I think that the drop in oil prices makes that forecast considerably less improbable, at least for the near term.

But as welcome as this remarkable drop in oil prices is to the overall health of the national economy, it does not correct some of the very disturbing underlying problems which we face in attaining sustained high levels of economic growth—problems which, in my judgment, will only be resolved with a far greater degree of nonideological cooperation than we have seen in recent years between the two branches.

The drop in oil prices will help the trade deficit, but we will still be importing tens of billions more in goods and services than we export. The amount we owe the rest of the world will still be the largest of any nation on Earth, and our external debt will still double in the next 12 months. The change in oil prices will increase real economic growth, but by considerably less than one-half of 1 percent in the judgment of most. It will probably improve the sagging growth in the Nation's productivity, but certainly not to the levels that are comparable to those we had experienced through most of our own history or to levels presently being enjoyed by some of our trading partners.

Last year's disappointing rates of 2.3 percent growth is even more disturbing when it is recognized that that has been the average level of performance over the past 5 years. For a half decade now we have grown at a rate nearly a full percentage point lower than the rate we experienced throughout the rest of the postwar era. The 6.5 million jobs created from 1981 through 1985 represent about half as many jobs as were created in the previous 5-year period. Job growth from 1981 through 1985 was the lowest in 20 years. The slower growth path of the 5 years translates into $175 billion in lost profits, wages, and buying power. It means fewer jobs, several million fewer jobs. It means jobs at lower wages, and it means that most families, particularly young families, continue on less real income than their counterparts of a decade ago.

Mr. Secretary, research performed for this committee indicates that this country has run into a serious problem since 1973, and I think it is a bipartisan problem. I think what it reflects is that since the oil crunch, the second oil crunch, hit us in 1973 that neither party has really learned how to run an economy yet with sufficient skill to keep it moving at full employment or near full employment, and it showed that as a result we have a serious squeeze developing on a significant portion of our population.

I graduated, for instance, from college in 1960, and what studies done for this committee have shown is that in 1960 the average worker who had left the family nest 10 years earlier, on average, by the time he was 30 was making about 30 percent more than that young worker's father had been making when that young worker had left home.

Today, that same 30-year-old on average is making about 10 percent less than his father made when he left home, and he is paying a much larger share of his personal income for things like paying the mortgage, utilities. In fact, since the mid-1970's we have seen it approximately double the share of that average 30-year-old worker's pay, which is going to simply pay the mortgage, pay real estate taxes, and pay overall for shelter.

I think that the significant improvement which is required in that picture will not come about simply as a result of changing oil prices; $15 oil may give us some breathing room, but it can't save us from our inability to come to an agreement on sensible economic policies. If we continue to have a political impasse between Capitol Hill and the White House, we are not likely to arrive at an agreement without a much greater degree of cooperation than we have had in the past.

We sit here, and it is the most frustrating experience that I have had in the 16 years that I have been in this Congress. We sit here all of us year after year gridlocked over fundamental issues on the budget, and we deal with the budget and we deal with the budget and we deal with the budget, and virtually nothing but the budget year after year, without a satisfactory resolution.

Mr. Secretary, I understand that it is not your job to put together the overall budget, but you do play an important role as the President's chief adviser on the revenue side of the ledger, and one of your jobs is to tell him how much we should expect to get in revenues under current law and whether that will cover the cost of the program.

Now, I know that the administration's position is that we need just to focus on cutting spending. Perhaps that is true. But in spite of the President's rhetorical positions on deficit reduction, he has never submitted to the Congress a budget that we can balance, and his budget for this year, according to the Congressional Budget Office, spends $15 billion more than the amount required just to reach the Gramm-Rudman target of $144 billion deficit for fiscal 1987.

It seems to me that if the President, with the tremendous resources that he has at his command in this Government for cutting the budget, cannot manage to find sufficient reductions even to meet Gramm-Rudman targets, let alone get to a responsible deficit below those targets, it is very difficult to expect a diverse institution such as the Congress with 535 different views and personalities to accomplish what the united branch of the executive government hasn't been able to do, at least in the judgment of the Congressional Budget Office.

Now, the administration may contend that these deficits came because Congress didn't enact the President's program, but I think the simple facts tell a different story. The facts show that we have these deficits because the Congress did substantially enact the program that was sent down by the President and that program simply didn't pay for itself.

Behind me is a chart, the middle chart here, which I think demonstrates a very interesting fact. It demonstrates that—it shows what the President has asked for by way of new appropriations since he came to office and what the Congress has in turn provided.

What it shows is that in one year, 1983, the Congress gave him more than he asked for and every other year they gave him less. Over the entire 5-year period the Congress has appropriated $3 billion less than the President has asked for.

So at least on the appropriation side if we are spending too much, it is because the President has asked that too much be spent, and the Congress has listened too much rather than too little to the wishes of the executive branch.

Over the years you and I have had a very constructive relationship. You are a thoughtful man. I think the President is very lucky to have you. I think the country is lucky to have you, and I recognize that in your public positions you have to defend the administration's position and want to on every issue and in every context.

But, Mr. Secretary, as I indicated to you when you appeared before the Appropriations Committee, when the spotlights are off and the cameras are gone and everybody has left the room, I think everybody really knows what has to be done. We have got to have spending cuts. We need to put everything on the table, however, not just domestic spending.

I just returned from my district. I am sure others have, too. I conducted a number of hearings on the President's budget while I was home, and all I can tell you is the reaction that I received from people is that they do not want to support a budget which contains a $34 or $36 billion increase in military spending, a $2 billion increase in foreign aid after you discount Exim, which is not a foreign aid program, and they don't want to finance those kinds of increases to be paid for by a 25-percent reduction in student aid, a $68 million reduction in cancer research, a reduction in the economic development programs down the line.

I think defense needs to be on the table. I think so should every other program, including entitlements. I have told my senior citizens, for instance, that you betcha I will not vote to limit their COLA's as long as everything else is not on the table. But the minute we can get everything on the table they have to be prepared to share in budget reductions just like everybody else, and I think the Congress itself is ready to take that position.

My concern, as I indicated to you the last time you appeared before the Appropriations Committee, my concern is that I don't believe we have the luxury of going through this Alphonse and Gaston routine between Republicans and Democrats, House and Senate, White House and Congress for 6 months about who is going to take the first move to really do what everybody privately knows in their hearts has to be done, and it just seems to me that the time to make a decision that we are going to put everything on the table for spending reductions and are going to include revenues in that three-legged approach to deficit reduction is now rather than later.

I deeply believe that if we wait until October 1, when we are jammed on a continuing resolution, we will probably screw it up because at that time the time pressures result in your doing a lot of things that you probably wouldn't have done if you had had more time to consider them.

I simply wanted to make that statement in setting the tone for this hearing this morning before you proceeded with your statement.

We have obviously a number of other issues we would like to talk with you about today, including the outlook for 1986, your views on monetary policy, the trade situation, the value of the dollar, which as you know is changing significantly, the foreign debt situation.

I would ask Congressman Lungren if he might have any comments on behalf of the minority before I ask you to proceed, and then we will get to individual members of the committee with their comments after your statement.

OPENING STATEMENT OF REPRESENTATIVE LUNGREN

Representative LUNGREN. Thank you, Mr. Chairman. Believe it or not, I do have a few comments to make on behalf of the minority.

Representative OBEY. I thought you would.

Representative LUNGREN. It is a pleasure to join you in welcoming the Secretary before us. I listened with interest to some of the points that you made and listened with interest to some points that other members of the majority have been making, and I suppose in that context I would just comment that until a few weeks ago the future budget outlook appeared particularly grim.

Unrestrained Federal spending we were told would result in a fiscal 1987 deficit in excess of $200 billion, even larger deficits loomed in the near future.

Huge tax increases we were told and are being told are inevitable. We have now been told it is part of a three-legged approach to answering the problem.

This reminds me that I have always noticed that people in three-legged races seemed to be much slower than people who are only running on their own two feet.

Large spending cuts would be necessary, devastating a broad range of programs. We have been told the FBI and the Coast Guard would be all but dismantled, the Defense Department crippled. The social safety net would absolutely be torn to shreds.

All this because of the draconian discipline mandated by the harsh Gramm-Rudman-Hollings amendment.

And then we had the release of the administration's budget estimates, and you would think that some would look at them with a little bit of respect and even some appreciation because they seem to be pretty good.

Unfortunately, the Senate seemed to assume that the projected baseline was ridiculously optimistic. The declining path of the Federal deficit to some seemed almost too good to be true, and if the baseline numbers were even in the ballpark, complying with Gramm-Rudman, I would think, might not require all the awful steps that we had thought it would beforehand.

Perhaps, I thought, advocates of higher taxes would be glad to hear the news and drop their demands for unneeded tax increases. If the revenues were not needed to reduce the deficit, I suppose what we would do would be to shield our own particular programs from the necessary cuts that we all recognize must come as part of the answer to the equation.

And last Tuesday the Congressional Budget Office released its baseline budget estimates, and generally, and surprisingly, they seemed to confirm those of the administration.

There are accounting differences between them, no doubt about it, and different economic assumptions, but interestingly enough, the downward deficit path still remains.

CBO's fiscal 1991 deficit is identical to that that the administration has presented to us, at $104 billion. We all know that is a large deficit, but that is not what we were talking about just a couple of months ago, and actually if we look at it, it appears to me to be one we can eliminate over a 5-year period of time.

I would have hoped that the nonpartisan CBO's baseline estimates would be accorded the same solemn respect as in previous years, that we would recognize that CBO suddenly has found the light again this year, but now there doesn't seem to be that same respect given to them, or at least the political respect given to them.

I hope they are not being attacked merely because they seem to confirm the administration's own projections. I hope the CBO is ready for the onslaught of nitpickers and second guessers who will now assign top priority to undermining the current forecast.

It just seems to me that we ought to view this as good news. Obviously, we still have a battle going. We all know we have to do something about the deficit. The President has presented his proposals. People are suggesting that he is holding back and he is waiting until the last moment, when he is going to throw the tax increases in there.

I take the President at his word. He said that is not his approach, and in fact, if you look at the estimates given to us by the administration and CBO, as consistent as they are, it would seem to me to be moving in the President's direction, and I hope that we would begin to recognize that.

The new CBO baseline puts us within $37 billion of the $144 billion deficit cap imposed by Gramm-Rudman. Given the $10 billion fudge factor built into the law, the Congress needs to cut approximately $27 billion to comply with Gramm-Rudman. That is less than 3 percent of projected Federal outlays.

I just think that is something Congress ought to be able to do. If we can't do that without raising taxes, we ought to just pack up and go home and send a whole new group here and see if they can do a better job.

I went home, as the chairman did, and I went all around my district, and people are willing to take cuts. We are taking cuts right now. People think defense has been protected.

I have got somewhere between 2,000 and 4,000 jobs that are scheduled to be lost in the shipbuilding and repair industry in my own district, and the folks back home, interestingly enough, are not as mad as you would think about losing their jobs as long as they think it is going to be part of the whole, and they just want to be treated fairly along with everybody else.

But I have not found a single person in my district, whether they are blue collar or white collar or pink collar, whatever you want to call it, who has suggested that what we need to do to answer the question is to increase taxes.

I think there is a recognition back home far more than we have seen here in Congress thus far that spending cuts are necessary and are acceptable.

So it seems to me that contrary to the fondest hopes of the tax and spend crowd, there is no reason to be stampeded into a counterproductive tax increase.

A tax increase is not needed under Gramm-Rudman if Congress does its job. A tax increase only runs the risk of undermining the economic growth that has created about 9.5 million jobs in the last 3 years.

I just am sorry I didn't bring my charts. We would have shown the number of jobs created over the last 3½ years. We could have shown them in comparison to where we were. We could have shown them where we are in comparison to other countries of the world.

I am sorry I didn't bring the charts on interest rates. As high as we all think they are, we know where they were.

I am sorry I didn't bring my charts on inflation. We had good things that have happened in the economy, and it seems to me we ought to build on those and not go into the counterproductive area of tax increases.

So with that nonpartisan, objective statement on my part, I thank the chairman for allowing me to speak, and I welcome the Secretary before us.

Representative OBEY. Mr. Secretary, please proceed.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY OF THE TREASURY

Secretary BAKER. Thank you, Mr. Chairman.

I have a prepared statement, which I would ask be entered into the record, and I will summarize it, if I might.

Representative OBEY. Sure.

Secretary BAKER. First of all, I am pleased to be here today.

As Congressman Lungren has said, we seek to build on the foundation of the solid economic performance that we believe has already taken place. The current economic expansion has now moved into its fourth year and shows few signs of slackening. While growth was relatively slow at some times during 1985, by yearend, the economy was gaining momentum.

Some favorable features of last year's economic performance, I think, deserve at least passing mention.

Consumer price inflation at 3.8 percent remained in the 3.8- to 4-percent range for the fourth year in a row and is down sharply from the double digit rate of 1980.

Employment has risen strongly in the current expansion by over 9.5 million people, as Congressman Lungren has just pointed out. The unemployment rate has been reduced to below 7 percent and further progress is expected.

Last year's financial market performance was also encouraging. Record amounts of credit flowed to private borrowers, despite the persistence of large Federal budget deficits. Short-term interest rates are down on average by about one-half of 1 percentage point in the past year, while many of the long-term rates are down by about 2 percentage points. The prime rate is down to 9½ percent, the lowest rate in over 7 years. Ideally, we would like to have seen interest rates come down even further than they have.

All of this added up to a year, however, of solid economic performance. The stage has been set for sustained expansion in output, jobs, and income. This is one of the most important prerequisites for improving the budget picture, as well as the financial security of the American people.

During the current expansion strong economic growth has been achieved in a much less inflationary environment than in the late 1970's. We must strive to extend that good record in the future.

The administration forecast calls for 4 percent real growth during the four quarters of 1986. This would seem, as you yourself have pointed out, to be a reasonable expectation. The consensus private forecast has been a little lower, around 3 percent. But the recent economic numbers are causing some upward adjustment in the private forecast.

The inflation outlook is also relatively promising, although the fall in the external value of the dollar will eventually begin to exert a little upward pressure.

The Federal Reserve obviously needs to remain alert to the needs of both the domestic and international financial situations. While they never lack for critics and there is always room for disagreement on the wisdom of some of their specific actions, it does seem to me that the Federal Reserve has been doing a good job recently.

I would like to turn briefly now to the influence of the international economy on our economic and fiscal situation. As a result of intensified efforts at promoting a favorable convergence of economic performance among the major industrial countries, we have seen some improvement in the world economy. We hope to build on the progress this year and to see stronger growth abroad. That trend would have a favorable impact on trade and economic growth in the United States.

Exchange markets have recognized these developments. Well over half of the dollar's rise on a real trade-weighted basis against other industrial countries from the end of 1980 to last winter's peaks has been reversed. This is good news for U.S. industry and it is good news for U.S. agriculture.

The U.S. trade deficit is likely to level off later this year. These developments should contribute to U.S. growth and to a more sustainable medium-term pattern of trade and current account balances. The G–5 meeting last September contributed to these developments. Our recent meeting in London showed that all countries were working to continue efforts for sustainable growth.

Another favorable development has been the downward movement in world petroleum prices. Although not without its costs, on balance this should increase growth and lower inflation in most of the world.

There are two major items on this year's fiscal agenda: deficit reduction and tax reform.

The large budget deficits that we face are due to excessive Federal spending. Certainly, it is not because the American people are undertaxed. As shown in the chart attached to my prepared statement, receipts are running a bit above the longrun historical average as a share of gross national product.

Despite frequent claims to the contrary, the 1981 Reagan tax cuts are not responsible for our current fiscal difficulties. Our problems are on the outlay side of the budget, and that is where the corrective action needs to be taken. It would seem that Congress shares this view and is serious about cutting growth in Federal spending.

Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly. Between fiscal 1985 and fiscal 1991, nominal Federal outlays would rise on average about 3 percent per year. In the prior 6-year period, the rate of growth was about 11 percent per year. Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP from 24 percent in 1985 to about 19 percent in 1991.

Receipts will be growing strongly in absolute terms, as the economy itself grows, but receipts would remain close to a 19-percent ratio to gross national product, which is slightly above our historical experience. Receipts are projected to rise by about an average of one-half of 1 percent annually between fiscal 1985 and fiscal 1991, close to the 8-percent rise averaged in the previous 6-year period. With receipts growing normally and outlay growth restrained to a lower path, the budget will move into balance by 1991.

The reduction in the growth of expenditures to balance the budget by fiscal year 1991 will not be easy, but the effort deserves strong bipartisan support. It can be done the hard, crude way via sequestration across the board, or it can be done more rationally and selectively with respect for appropriate priorities.

The President's budget is carefully drawn to meet the Gramm-Rudman targets, while preserving essential programs of the highest national priority.

The only alternatives to the domestic spending cuts emphasized in this budget are to raise taxes or to lower defense spending or to cut Social Security benefits, none of which are acceptable to the administration. There should be no illusion that tax increases will somehow provide an easy way out. The President has expressed his views on this issue very clearly. He is firmly opposed to damaging the economy by increasing taxes. Defense, which is the most essential duty of the Federal Government, must be maintained. So must the social safety net, including Social Security and entitlement programs for the needy.

Our other major domestic policy priority is to achieve meaningful tax reform legislation. The bill passed last year by the House of Representatives is a good start, but it is not a final product. The Senate Finance Committee has begun consideration of tax reform and the administration has pledged its full cooperation in improving the House legislation. Our major desired changes include: full $2,000 personal exemptions for both itemizers and nonitemizers, at least for lower and middle-income taxpayers; and provision of capital costs recovery allowances adequate to promote economic growth and the protection of those allowances against inflation; and a top rate no higher than 35 percent.

Tax reform remains a top priority item on the President's agenda. We will work in a bipartisan spirit to achieve meaningful tax reform this year. But let me be very clear that the President will not compromise on matters of principle, and he will not permit tax reform to degenerate into a tax increase in disguise.

Thank you very much, Mr. Chairman.

[The prepared statement of Secretary Baker follows:]

Prepared Statement of Hon. James A. Baker III

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the state of the economy and the new budgetary path. The major economic objectives of the Administration have been described by President Reagan in his State of the Union Message. Further details on this year's economic and budgetary outlook have been provided in the President's Budget and Economic Report. My remarks are an overview of the current situation.

We seek to build on the foundation of the solid economic performance that has already taken place. The current economic expansion has now moved into its fourth year and shows few signs of slackening. Growth was relatively slow at some times during 1985, but by year-end the economy was gaining momentum.

Some favorable features of last year's economic performance deserve at least passing mention.

- Consumer price inflation at 3.8 percent remained in the 3.8 to 4 percent range for the fourth year in a row. A table attached to my prepared statement shows the steady progress that has been made since 1980 when all of the measures of price performance were rising in the double-digit range.

- Employment has risen strongly in the current expansion, by over 9-1/2 million people. The unemployment rate has been reduced to below 7 percent and further progress is expected. The U.S. economy continues to display great job-creating ability.

- Last year's financial market performance was also encouraging. Record amounts of credit flowed to private borrowers, despite the persistence of large Federal budget deficits. Short-term interest rates are down on average by about 1/2 percentage point in the past year while many of the long-term rates are down by about two percentage points. The prime rate is down to 9-1/2 percent, the lowest rate in 7 years. Ideally, we would like to have seen interest rates come down even further than they have.

All of this added up to a year of solid economic performance in 1985. The latest economic information is generally favorable. Employment rose sharply in January and the unemployment rate fell. Other statistics have not been quite as strong but the year is off to a good start. The stage has been set for sustained expansion in output, jobs and income.

Sustained economic expansion is one of the most important prerequisites for improving the budget picture, as well as the financial security of the American people. During the current expansion, strong economic growth has been achieved in a much less inflationary environment than in the late 1970's. We must strive to extend that good record into the future.

The Administration forecast calls for 4 percent real growth during the four quarters of 1986. This would seem to be a reasonable expectation. The consensus private forecast has been a little lower, around 3 percent. But the recent economic numbers are causing some upward adjustment in the private forecasts. Those of us who advise the President on these matters feel that the current Administration projections are inherently reasonable although we also recognize that economic forecasting is at best an uncertain art.

The inflation outlook is also relatively promising, although the fall in the external value of the dollar will eventually begin to exert a little upward pressure.

The Federal Reserve obviously needs to remain alert to the needs of both the domestic and international financial situations. While they never lack for critics and there is always room for disagreement on the wisdom of some of their specific actions, it seems to me that the Federal Reserve has been doing a good job recently.

I would like to turn briefly now to the influence of the international economy on our own economic and fiscal situation. As a result of intensified efforts at promoting a favorable convergence of economic performance among the major industrial countries we have seen some improvement in the world economy. We expect to build on the progress this year. On balance, we expect stronger European and LDC domestic demand growth this year as they continue the process of shifting from export-led to domestic-led growth. Unfortunately there may be some weakening in Japanese growth as the previous stimulus from the trade sector is sharply reduced.

Exchange markets have recognized these generally favorable developments. The decline of the dollar since its peak last winter has been substantial. The yen is at a seven-year high against the dollar. Well over half of the dollar's rise on a real trade-weighted basis against other industrial countries from the end of 1980 to last winter's peaks has been reversed. This is good news for U.S. industry and agriculture. The U.S. trade deficit is likely to level off later this year. These developments should contribute to a more sustainable medium-term pattern of trade and current account balances. The G-5 meeting last September contributed to these developments. Our recent meeting in London showed that all countries were working to continue efforts for sustainable growth.

Another favorable development has been the downward movement in world petroleum prices. Although not without its costs, on balance this should strengthen growth and lower inflation in most of the world. A few countries and firms will experience problems, but with the U.S. debt initiative and a strongly growing world economy these problems can be handled.

While the international debt situation has continued to improve, economic growth in many debtor countries has remained unsatisfactory, and requires greater emphasis on structural policy reforms within those nations, buttressed by additional international financial support. As you know, the United States proposed last October at Seoul, Korea a "Program for Sustained Growth", involving mutually reinforcing actions by the debtor countries, the international financial institutions, and the commercial banks. The response has been very encouraging, with broad statements of support from the major bank groups in the U.S. and other key creditor nations, from the multilateral institutions and in principle from many of the debtor nations.

* * *

There are two major items on this year's fiscal agenda: deficit reduction and tax reform.

The President's budget for fiscal 1987 provides a detailed plan, satisfying the requirements of the Gramm-Rudman-Hollings legislation, by which a balanced budget can be achieved by fiscal 1991. The large budget deficits that we currently face are due to excessive Federal spending. Certainly it is not because the American people are undertaxed. As shown in the chart attached to my prepared testimony, receipts are running a bit above the long run historical average as a share of GNP. Despite frequent claims to the contrary, the 1981 Reagan tax cuts are not responsible for our current fiscal difficulties.

Our problems are on the outlay side of the budget, and that is where the corrective action needs to be taken. It would seem that Congress shares this view and is serious about cutting growth in spending. Outlays will continue to grow in absolute terms along the path projected in the new budget, but the rate of advance will be reduced significantly. Between FY 1985 and FY 1991, nominal Federal outlays would rise on average about 3 percent per year. In the prior six-year period, 1979-1985, the rate of growth was about 11 percent per year. Along the path projected in the new budget, Federal outlays would decline steadily as a ratio to GNP from 24 percent in 1985 to about 19 percent in 1991.

Receipts will be growing strongly in absolute terms as the economy itself grows, but receipts would remain close to a 19 percent ratio to GNP -- slightly above historical experience. Receipts are projected to rise by about an average 7-1/2 percent annually between FY 1985 and FY 1991, close to the 8 percent rise averaged in the previous 6 year period. With receipts growing normally and outlay growth restrained to a lower path, the budget will move into balance by 1991.

The reduction in the growth of expenditure required to balance the budget by fiscal year 1991 will not be easy, but the effort deserves strong bipartisan support. It can be done the hard, crude way, via sequestration across the board. Or it can be can be done more rationally and selectively, with respect for appropriate priorities. The President's budget is carefully drawn to meet the Gramm-Rudman-Hollings targets while preserving essential programs of the highest national priority.

The only alternatives to the domestic spending cuts emphasized in the President's budget are to raise taxes, to lower defense spending, or to cut social security benefits, none of which are acceptable. There should be no illusion that tax increases will somehow provide an easy way out. The President has expressed his views on this issue very clearly. He is firmly opposed to damaging the economy by increasing taxes. Defense, which is the most essential duty of the Federal Government, must be maintained. So must the social safety net, including social security and entitlement programs for the needy.

The outlay reductions would be expected to bring down interest rates with a beneficial impact on the entire economy. In addition, lower interest rates and a declining budget deficit will moderate the rapid rise in interest expense that has developed. This will free up funds for growth in essential programs.

The time has come to reduce what has clearly become an excessive rate of growth in Federal spending and to move toward a balanced Federal budget.

* * *

Our other major domestic policy priority is to achieve meaningful tax reform legislation. The bill passed last year by the House of Representatives is a good start but not a final product. Our primary concerns are the following:

- o the bill lowers marginal tax rates but the top individual rate of 38 percent and the corporate rate of 36 percent are still too high;

- o the bill raises the personal exemption to $2000, but to only $1500 for taxpayers who itemize deductions;

- o the bill fails to maintain the cost of capital at sufficiently low levels to promote economic growth.

The Senate Finance Committee has begun consideration of tax reform and the Administration has pledged its full cooperation in improving the House legislation. Our major desired changes include:

- o full $2000 personal exemptions for both itemizers and nonitemizers, at least for lower and middle-income taxpayers;

- o provision of adequate capital cost recovery allowances and the protection of those allowances against inflation;

- o a top tax rate no higher than 35 percent.

Tax reform remains a top priority item on the President's agenda. We will work in a bipartisan spirit to achieve meaningful tax reform this year. But let me be very clear that the President will not compromise on matters of principle and he will not permit tax reform to degenerate into a tax increase in disguise.

Conclusions

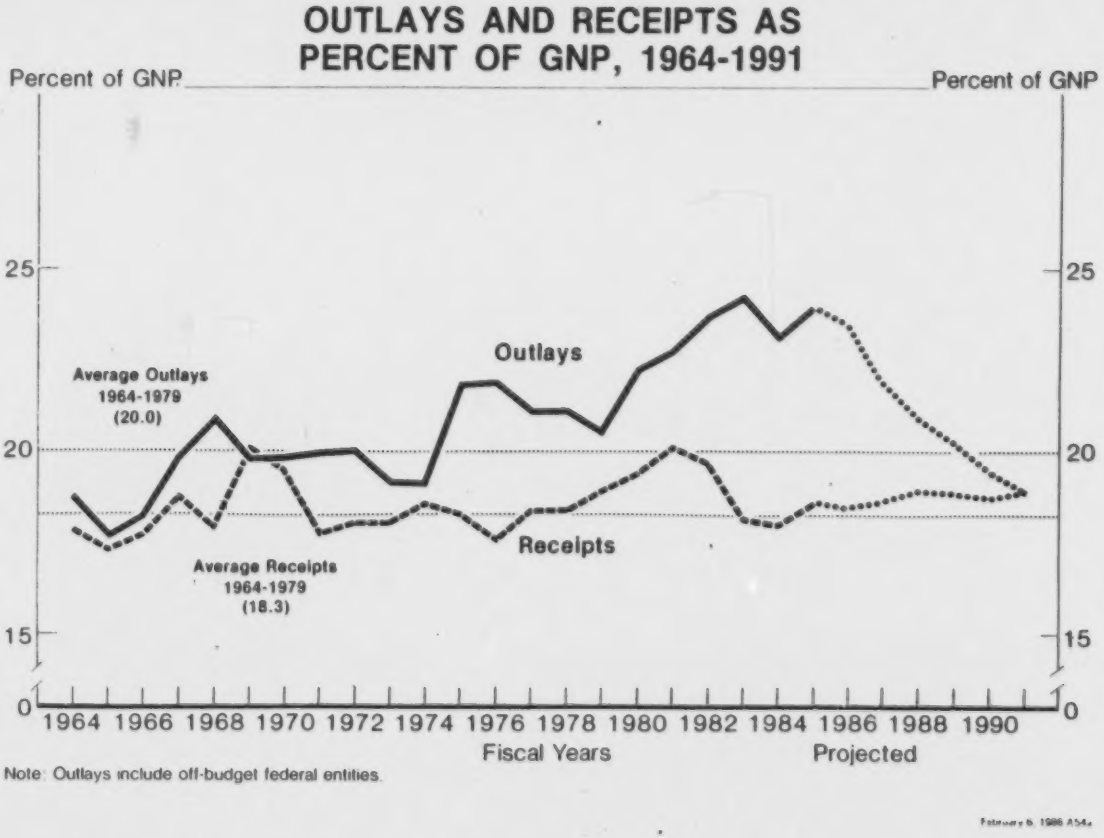
The U.S. economy turned in a solid showing last year and the outlook this year is for stronger real growth without much increase in inflation. Internationally, as well, there was progress during 1985 and we will be working to build on that foundation. Our major domestic agenda items are reduction of an excessive rate of growth in Federal spending as we move toward a balanced budget, and meaningful tax reform for the American people. We think that both of these efforts deserve and will receive strong bipartisan support.

RECENT PROGRESS AGAINST INFLATION

(percent change, annual rate, during period indicated)

	1980	1981	1982	1983	1984	1985
GNP: Implicit price deflator	9.9	8.7	5.2	3.5	4.1	3.1
Fixed-weighted basis	9.8	8.5	5.0	3.8	4.2	3.5
Consumer price index	12.4	8.9	3.9	3.8	4.0	3.8
Producer price index (wholesale prices)	11.8	7.1	3.7	0.6	1.7	1.8

Note: Fourth quarter to fourth quarter for GNP deflator, December to December for CPI and PPI


OUTLAYS AND RECEIPTS AS
PERCENT OF GNP, 1964-1991
Percent of GNP
Percent of GNP
25
20
15
0
Outlays
Average Outlays
1964-1979
(20.0)
Receipts
Average Receipts
1964-1979
(18.3)
1964 1966 1968 1970 1972 1974 1976 1978 1980 1982 1984 1986 1988 1990
Fiscal Years
Projected
Note: Outlays include off-budget federal entities.

Representative OBEY. Thank you, Mr. Secretary.

Mr. Secretary, I would like to get right to the last two points you made in your statement, one on revenues and one on the need to protect defense and entitlement programs.

I recognize the administration is going to keep following this line, and I recognize that properly our party's leadership is going to keep following this line, but as I said last time you were before the Appropriations Committee, what I really find so nauseating in this city is that everybody on all sides keeps repeating their own baloney so often that they believe it. And the worse thing that can happen in this town is that if you believe your own nonsense. And I really believe it is nonsense to suggest that there is enough money left in that one little domestic discretionary portion of the budget to suggest that that's where all the deficit reductions are going to come from. And I would like to show you why.

If you take a look at that middle chart, the middle chart compares what percentage of the public's tax dollar went to what in 1980 versus what we have in the President's budget today. I would like to run through what those numbers show.

If you start at the bottom, for instance, with the little green piece of the pie which represents the 7 cents on the dollar that went to all programs to support the nonelderly poor, in other words, welfare for anybody under age 65, in 1980 that took 7 cents on the dollar. Under the President's budget, that is going to be reduced to about 5½ cents on the dollar, roughly a 20-percent cut. It's gone up in nominal dollar terms, but in terms of percentage of the budget, it's gone down slightly.

Then moving around to the right, the white piece, the small white piece on the top chart, indicates the 9 cents out of every dollar that went to interest in 1980. As you can see, in the President's budget it has grown significantly on the bottom chart for 1987. It is now 17.7 percent of the total budget amount.

The third piece is the elderly and disabled portion, which you indicated that we had an obligation to protect. In 1980, as you can see on the top chart, it represented 37 cents out of every dollar, $217 billion at the time. Now under the President's budget, it represents about $377 billion or 37 percent of the budget, still just about the same, give or take a couple of tenths of a point on the decimal side.

Then you get to the red piece, which is military budget, which, as you know, the President increases 12 percent this year over pre-Gramm-Rudman baselines.

And I see you shaking your head no, but if you could see what we passed by way of appropriations rather than what we passed in a budget resolution that was never adopted, that is what it is. It is a 12-percent growth, not in real terms, a 12-percent nominal growth.

As a percentage of our Federal dollar, that means that defense and foreign aid and the maintenance of our Embassies around the world, for instance, cost 25 cents on the dollar in 1980. Under the President's budget, it would cost us 31 cents on the dollar, roughly.

Then you get everything else in the budget, which, in 1980 represented 21 percent of the budget, $121 billion, and today represents $110 billion or about 11 percent of the budget.

That represents two portions of the budget. It represents what we pay just to keep the Government running, the FBI, the courts, the prisons, IRS, you name it. It also represents the investment portion of the budget. Everything we invest in kids by way of education, everything we invest in workers by way of job training, everything we invest in research, whether it is scientific research to keep us on the cutting edge of competition, or whether it is health research.

That has been reduced from 1980 through the President's budget today from 21 percent to 11 percent, just about half of what we did—half the amount that it represented in 1980.

If we adopt the President's budget in toto, what that indicates is that there is $110 billion left in that remainder portion of the budget for fiscal 1988, 1989, you name it. And yet under the President's estimate, we are going to be left with $144 billion in deficit, if we adopt the President's budget this year. That means that we can probably do anything we want to paper over what happens this year, if we really want to get innovative about it. But the fact is that if we are talking about long-term solutions to our deficit problem, we are kidding people if we are telling them that we can reduce $144 billion in deficits that will remain after the President's budget is passed. We are kidding them if we tell them we can eliminate $144 billion in deficits by focusing on that remaining $110 billion portion of the budget.

If, as you say in your testimony, the President wants to defend the blue piece of the pie, the elderly and entitlements portion, and if he wants to defend the defense, which is the red piece of the pie, and we have to pay the white piece of the pie, which is interest, what you are telling us that we are only going to focus on the domestic discretionary portion of the budget. CBO tells us that domestic discretionary spending in the budget, as of now, this year, is lower as a percentage of GNP than it was in 1962 before the Great Society ever began.

So, Mr. Secretary, I would love to believe that we could get to the deficit reduction that you are talking about on the road you are talking about, but I think the numbers indicate that unless you repeal the basic laws of mathematics, you simply can't do it.

I welcome your response.

Secretary BAKER. Mr. Chairman, I am not sure I agree with your $110 billion figure. That was what I was just asking the staff here about, but let me tell you how I think you do it.

In the first place, it is a one-time task. If you were to pass the President's budget, and if you agree that the assumptions are reasonable, and if the Congress and the executive branch don't decide to spend a lot more money between now and 1991, you will get to balance in 1991 by doing nothing more. Now you yourself—or I guess it was Congressman Lungren—indicated earlier that on a current services basis, we are looking at a deficit of roughly $104 billion in 1991. That is on the basis of a bipartisan estimate by CBO, and that is a far different picture.

Representative OBEY. Mr. Secretary, doesn't that assume, for instance, that even though the CBO thinks it is unrealistic, isn't CBO required, under the baselines, to assume that there would be, for

instance, no agricultural program next year? That isn't really a realistic assumption, is it?

Secretary BAKER. I don't think so at all. I think what they are assuming, and I am not positive about this, but I think they are assuming the Food Security Act of 1985, which you just passed. But let me finish if I might. The fact of the matter is that the budget picture is, indeed, brighter than it was when we were talking about this in December and January. At that time people were talking about $50 billion or $60 billion in sequestration, if it occurred with respect to fiscal 1987.

The President has sent a budget up that does meet the Gramm-Rudman targets. I recognize that there is a difference of opinion between CBO and OMB with respect to about $14 billion in defense outlays. We think our numbers are accurate, and we stand behind them. The position that we take is, that the President's budget does meet the Gramm-Rudman targets. And my number for 1987 current services domestic program spending is $418 billion—exclusive, of course, of Social Security. And I don't know where the difference is between the $110 billion and the $418 billion. Perhaps we could explore that.

But all we're suggesting, Mr. Chairman, in this budget, is that the Congress bite the bullet one time and cut 5 percent out of that $418 billion in domestic program spending. If you do that, we're talking about $23 billion in cuts, now not $38 billion or some higher figure, because the budget contains $6.3 billion in additional revenues. It contains about $3 billion in sales of assets, about $5 billion in other offsetting collections and interest saving, and it contains a $2.7 billion saving in defense from the fiscal 1986 Budget Resolution.

So what we really think you are talking about is a $23 billion hit, one time, to domestic program spending, to put this budget on a path to balance.

Representative OBEY. Well, Mr. Secretary, I'll tell you what I will do, I will provide you with a listing of each program that we have included in each category, in order to demonstrate to you exactly where—exactly how we arrive at those categories and those numbers. You can respond for the record, and I will respond for the record, and we will compare charts and see if there is really any disagreement on the numbers. I doubt that there will be.

[The information referred to follows:]

The attached table shows for FY 1987, on a current services basis, the composition of domestic Federal programs, other than social security and net interest, that comprise the estimated $418 billion total referred to by Secretary Baker and requested for the record by Chairman Obey in the Joint Economic Committee hearing indicated above. The source of this table is page 11, "Highlights of President's FY 1987 Budget", published by the Office of Management and Budget, February, 1986.

MAJOR BUDGET COMPONENTS: CURRENT SERVICES BASELINE
(outlays in billions of dollars)

	FY 86	FY 87	FY 88	FY 89	FY 90	FY 91
o Net Interest	141.5	149.2	148.7	142.8	135.1	128.6
o Social Security	197.6	209.6	223.6	237.5	252.4	261.1
o National Defense						
Department of Defense	258.4	276.7	295.0	319.3	344.0	369.0
DOE Nuclear Weapons, Other	7.4	8.2	8.7	9.3	10.1	10.4
Total, National Defense	265.8	284.9	303.7	328.6	354.1	379.4
o Other Federal Programs						
Income Support for Needy	40.3	40.1	42.8	43.1	43.1	44.5
Major Medical, Retirement, and Benefit Programs	179.4	191.7	209.3	227.2	245.7	264.4
Other Government Activities:						
Foreign Affairs, Space, Coast Guard.	26.5	26.8	26.5	26.8	27.3	28.1
Transportation and Public Works	30.0	29.4	29.6	30.5	32.1	32.7
Local Development and Economic Subsidies	30.0	25.1	28.5	25.8	25.5	25.8
Agriculture Credit and Subsidies	26.3	22.0	21.8	21.5	18.9	14.8
Education, Health and Social Services	32.8	32.6	33.3	34.1	34.8	35.6
Energy Research, Subsidized Power, Public Lands and Parks	6.2	6.5	6.7	6.3	6.4	6.6
Law Enforcement, and Other Core Functions	40.3	43.6	43.7	44.5	45.9	46.5
Total, Other Gov't. Activities	192.1	186.1	190.1	189.5	190.9	190.2
Total, Other Federal Programs	411.7	417.9	442.0	459.8	479.8	499.1
o Gross Federal Outlays	1016.6	1061.7	1118.0	1168.8	1221.2	1268.3
o Undistributed Offsetting Receipts	-34.6	-35.8	-40.7	-40.7	-41.9	-44.2
o Net Federal Outlays	982.0	1025.9	1077.3	1128.1	1179.3	1224.1

Representative OBEY. Let me make another point. In your prepared statement, you state very clearly that the reason for the deficit is solely because we have too much spending, rather than because we have too little revenue. And you indicate that on a historical basis, the revenue provided to the Government is, if anything, slightly above the average for the base years that you use in your testimony.

Secretary BAKER. Yes, sir.

Representative OBEY. Now, I will grant that that is correct. I will grant that we need additional spending cuts, provided that they are across-the-board, but I would challenge your assumption that the administration is being consistent in its position on the percentage of revenues, as a percentage of GNP, for this reason.

In your prepared statement, you indicate that it is essential to maintain the social safety net, including Social Security and entitlement programs. I assume that means, therefore, that if the President is for the benefits that are being paid out under Social Security, he is also for the taxes that are necessary to finance those benefits. But the problem is, when you subtract from the revenue picture, and as you know, the administration has supported and virtually everybody else has supported, because I guess it is the easy political thing to do, they have supported taking Social Security off budget.

Well, if you take Social Security revenues out of the budget, it is interesting to me to see that, in fact, for general purpose revenues, if you take a look at the chart to the right, we have had a decline over the period that you are talking about, in terms of the percentage of general purpose revenues that we collect in this country. We have had a decline from slightly over 14 percent, about 14.4 percent in 1963, to a little over 12 percent this year. And it seems to me that that indicates that if both—let's take parties at their word.

Let's say that the President is really sincere on Social Security, and let's say the Democrats are going to stick to their position on Social Security, because neither one of us apparently is going to try to level with people on it. Well, if that is the case, then it would seem to me that you have to take, as a consequence of that position, you have to take cognizance of the fact that our revenue base for the rest of government has declined. And when Rudy Penner tells us that today, as a percentage of GNP, that the amount of money that we spend on domestic discretionary programs is smaller than it was in 1962 before anybody ever spent a dime on any of these great society programs, that tells me that it is perfectly understandable why the public doesn't want to see further reductions in health research. They don't want to see cancer research reduced by $68 million. They don't want to see heart disease reduced by $61 million. They don't want to see AIDS research reduced by $30 million. They don't want to see student aid reduced by one-fourth. They don't want to see agriculture reduced by $8 billion. They don't want to see transportation reduced by $6 billion. They don't want to see Medicare and Medicaid reduced by $4½ billion, if defense is being left off the table, if entitlements are being left off the table, if Social Security is being left off the table, and if we can't even consider using a portion of the revenues that we pick up from a minimum tax on corporations and individuals who aren't paying

any taxes, in order to try to attack the deficit before we pass around another round of tax reductions to high-income people.

Again, I invite your response.

Secretary BAKER. Mr. Chairman, I don't argue with your chart over here on the left, but I don't think it's germane, quite frankly, unless and until Social Security is off the budget. It isn't off the budget, it's part of the unified——

Representative OBEY. Well, it's off the table, under the President's political position and our leadership's position.

Secretary BAKER. Well, and we all know why, too, because we know——

Representative OBEY. But, shouldn't it be on the table? If we're really—if the Democrats quit dancing and the White House quits dancing, shouldn't it all be on the table?

Secretary BAKER. Well, Congressman, you, yourself, know as well as anybody that that is perhaps politically the most volatile issue we have in our society today. And if——

Representative OBEY. Unless both party leaders get together on it. Social Security was volatile 5 years ago, but we all got together and it dissolved as an issue because we did what was responsible and people recognized——

Secretary BAKER. We got together in 1983——

Representative OBEY [continuing]. There was no other choice.

Secretary BAKER. We got together in 1983 and we worked out, I think, a very satisfactory solution to the financial security problem with respect to the Social Security Trust Fund. And we put it on track so that it is financially secure now, well into the next century.

I had a little bit to do with that, and I'm rather proud of the fact that we were able to accomplish it. My only point is this:

If you're going to talk about Social Security, it is encumbent, at least in my view, that the leadership of the Democratic Party lead the parade, because that issue has been "demogoged" to death against our party.

The President's position——

Representative OBEY. What about the issue of taxes being demagoged by yours, sir?

Secretary BAKER. We didn't raise the——

Representative OBEY. If we both drop the demagoguery and both do what we know needs to be done——

Secretary BAKER. Congressman, let me suggest that we didn't raise the issue of taxes in the last election. It was raised by the other side. It became one of the major issues in the election.

The President of the United States didn't raise it; his opponent did. You mentioned defense a minute ago. Let me talk about defense before we get to taxes.

You say defense isn't on the table. In the 1986 budget resolution, the President agreed—you can say he didn't agree with the House, but he certainly agreed over there with the other body—to a budget resolution that cut defense from his request by $290 billion over 5 years. Defense has very much been on the table.

Representative OBEY. Well, Mr. Secretary, I've taken too much time already. Let me simply say that I would love to be able to discuss programs which are my first priority in terms of cuts I want

to take from the amount that I'd like to get that's new before we talk about this, because I'd love to do that same thing on my program.

Let me simply say that unless we take everything, put it all on the table, next time you appear before me on the Foreign Operations Subcommittee, we aren't going to have a hell of a lot to talk about, frankly, because while I regret it, I don't believe I have any choice but to say that, with the exception of meeting our Camp David requirements, if this country can't afford to pay its bills and if we're expected to finance a $2 billion increase in foreign aid out of the kind of domestic cuts that I've been talking about, then, as far as I'm concerned, we've reached the point—the reason we have the foreign aid program, one of the reasons, is because we are a great country with international responsibilities and we recognize that we have to do some things that are expensive and a part of our duty.

But if we aren't going to face up to the duty to pay for those programs, and if we're going to try to gouge what we're doing at home, then it seems to me that it's about time we recognized this country can't afford a foreign aid program, whether it's the banks or whether it's aid to Bangladesh, or whether it is military aid.

Secretary BAKER. May I respond to that before you pass the microphone? Again, my numbers show an increase in foreign aid of $1.5 billion. I suppose that's because we're looking at it from the CR level.

But, whether it's $1.5 or $2 billion, $600 million of it is for the simple, one-time purpose, of upgrading security at our embassies around the world.

Representative OBEY. No, it's not. That doesn't come under our jurisdiction. That comes under State-Justice Subcommittee, which is an entirely different bill.

Secretary BAKER. Well, but it's embodied in the $2 billion increase, is it not?

Representative OBEY. No. No, it is not.

Secretary BAKER. OK.

[The following submission was subsequently supplied for the record:]

The discussion about foreign aid spending was left unresolved. The following submission reconciles the differing points of view expressed by Chairman Obey and Secretary Baker.

Chairman Obey and Secretary Baker were talking about different concepts, both in terms of numbers and budget functions. In terms of numbers, the Chairman apparently was talking about the difference between the FY '87 budget authority request and the FY '86 budget authority request, which is $2 billion. Secretary Baker was talking about the outlay increase proposed by the President for FY '87 over current services for FY '87 (which coincidentially is the same amount as the level approved in the Congressional Resolution of the year before). Both are valid concepts. Regarding the discussion of spending for security, Chairman Obey's remarks appear to contradict the Secretary's figures. Chairman Obey apparently was concerned with the funding for the international security assistance category, which is under the jurisdiction of Mr. Obey's operations subcommittee of the Appropriations Committee. Secretary Baker was talking about the $600 million increase for embassy security, which is not part of the international security assistance category and which is funded through the Commerce-State-Justice appropriations subcommittee.

Representative OBEY. Congressman Lungren.

Representative LUNGREN. Thank you, Mr. Chairman.

I think I was one of those who thought that we ought not take Social Security off the table, but I'm also a member of the party that managed to lose 26 seats in 1982 when the President had the courage early in his administration to come up with suggestions that the Social Security system was in financial difficulty.

As I recall, he made something like 15 or 17 recommendations and I recall the response we got. I remember the good Congressman, Claude Pepper, coming into my district and other districts talking about how the Republicans were out to kill Social Security.

And after that election was over and we lost 26 seats, bipartisanship was born. And we managed to come together with a resolution of the problem—not satisfactory on all parts.

So I recognize what you're saying, and I think all should recognize what you're saying. I guess Herbert Hoover is no longer around, but Social Security is the way to beat something over the heads of our party.

And it makes it rather difficult to say that, well, we'll wait until the President puts it on the table and then we'll deal with everything then.

As I understand it, whether you've got these charts or not, the administration budget, when presented to us, was a budget that showed where those cuts are going to occur across the board. Right?

Secretary BAKER. That's right.

Representative LUNGREN. I mean, you went specifically program by program by program.

Secretary BAKER. Absolutely.

Representative LUNGREN. And so the administration is willing to stand by the suggestions they have made in their budget and to defend those various cuts. And, in some cases, we're not talking about cuts in absolute numbers, we're talking about cuts in projected increases.

Are we not?

Secretary BAKER. That's correct

Representative LUNGREN. Such as research in AIDS, for instance?

Secretary BAKER. Yes, sir.

Representative LUNGREN. One of the things that I'm not sure is specifically understood, and you started to address it, I think, in your first response to the first question, was the fact that if we are able to get cuts in year one, those cuts have an impact beyond the numbers in year one in the subsequent years.

Secretary BAKER. That's——

Representative LUNGREN. In other words, that has the effect of reducing the baseline so that, in fact, the draconian nature of cuts in maybe years four and five will not be there if the baseline is less.

Isn't that correct?

Secretary BAKER. That's correct.

Representative LUNGREN. So, as I understand it, with the budget that was presented by the administration, it contains a forecast that the 1986 sequester of $11.7 billion would involve reductions in budget authority sufficient to reduce fiscal year 1987 outlays by about $18 billion.

Is that correct?

Secretary BAKER. I'm not sure of that exact number, Congressman, but it sounds about in the ballpark.

Representative LUNGREN. We've been talking about defense here and you've mentioned that the President agreed to put defense on the table, agreed to a cut, and over how many billions of dollars?

Secretary BAKER. Two-hundred and ninety billion dollars over 5 years from his requested level.

Representative LUNGREN. Can you tell me where the President's 1987 budget recommendations for defense spending compares with that of the Carter administration and projections they made in their last year?

Secretary BAKER. The request in the President's budget puts defense at slightly more than 6 percent of gross national product, which is less than the defense budget was in any peacetime year under either the Johnson administration or the Kennedy administration.

Representative LUNGREN. All right. And do you recall what the projection was from the Carter administration in the last year as to what it would be for 1987?

Secretary BAKER. It's under, well, I only recall that defense as a percentage of GNP in the President's budget is near the last Carter budget baseline.

Representative LUNGREN. So, Ronald Reagan is presenting a budget that's less than what Jimmy Carter did as a suggestion for the baseline for the same year?

Secretary BAKER. As I recall with respect to defense as a percentage of GNP they are close, Congressman. Defense has been very much on the table over the course of the past few years.

Representative LUNGREN. Let me ask you a question if you care to comment on Federal Reserve policy.

Do you have a suggestion as to how the Federal Reserve policy should be established in terms of its response to fiscal tightening under Gramm-Rudman?

In other words, if Congress, in fact, does do the job as projected by Gramm-Rudman—if the Congress and the President working together, if together we do the job in tightening fiscally under Gramm-Rudman, should that give any signals to the Federal Reserve in terms of its policy?

Secretary BAKER. Well, it may give the Federal Reserve a little bit more latitude in terms of setting monetary policy. I'm not sure that it automatically follows that there ought to be, as a result of that fact alone, an easing by the Federal Reserve.

As you note in my prepared statement, I have felt for the year that I've been Secretary of the Treasury, that the Federal Reserve has been doing a good job.

Representative LUNGREN. Let me ask a question on an entirely different subject. As a Californian, I suppose, I have some mixed feelings about the slide in oil prices. It certainly starts to affect some of the revenues to the State of California. And perhaps maybe as a Texan, you may have some mixed feelings about the slide in oil prices.

What impact does this slide in oil prices have on the revenues collected by the Treasury? Or do we have any projections on that?

Secretary BAKER. Well, I don't have anything specific right now but, overall, I would think that it would increase the revenues collected as a consequence of further cutting inflation and increasing the possibilities for growth in the economy overall.

I think on balance it would clearly be on that side of the equation. Windfall profit tax receipts would be down by some slight degree, but that drop would be more than offset by income and gasoline taxes.

Representative LUNGREN. Thank you, Mr. Secretary. I appreciate the opportunity to hear from you and your very strong defense in support of the budget presented by this administration.

Secretary BAKER. May I just say one final thing, Congressman? And I think you made this point. We have total outlays in this budget of $994 billion.

And it's quite true, as the chairman has pointed out, that some of those areas are off limits—Social Security, defense—in the President's budget, and interest.

I think the fact remains that there is something in the neighborhood of a little over $400 billion in domestic program spending of one kind or another. And we are asking that the Congress cut $23 billion, or roughly 5 percent of that domestic spending.

If you do it one time, assuming the economic assumptions are right, you get to a balanced budget in 1991.

Representative OBEY. Congressman Scheuer.

OPENING STATEMENT OF REPRESENTATIVE SCHEUER

Representative SCHEUER. Thank you very much, Mr. Chairman.

Secretary BAKER, we welcome you here and I'm cutting through some of the fog that we seem to generate up here. This is a bipartisan committee, and we care about our country. We only have one President. We only have one economy. We want it to work.

When the state of our economy, for whatever reasons, involves a gradual and perhaps not so gradual disinvestment, where we are exporting 3,000 jobs a day, or a million jobs a year, when whole industries are being devastated because of an over-priced dollar and the inability of whole industries to compete in international commerce because of that, we're all concerned.

And we are concerned as responsible Americans and responsible members of what we feel proudly is the world's greatest legislative body.

And, of course, one of the problems is how we're going to meet the deficit. When you speak to us here this morning and you repeat the President's position, that he's adamant on the question of standing pat on taxes and looking only to reduce the expenditures in the domestic economy while increasing the military, yours and his are not the only two voices that we're hearing.

Those two voices come to us in a gestalt. We have an environment in our country where we have achieved, in a sort of rough and tumble way that is typical of a democracy, we've achieved a consensus in this country, finally, that some kind of tax increases of whatever size and description are necessary.

And we've achieved it in the Congress, between the two parties, between the two Houses. We've achieved that in our business com-

munity. I come from New York City, where we have a pretty sophisticated financial community.

You won't hear a banker, a businessman, an economist virtually in the country who doesn't feel that the time has come for us to get down to the serious business of discussing some kind of increased taxes as part of a mix. There is virtually not a leading member of the Republican Senate Leadership who hasn't said publicly that taxes must be part of the mix.

Now, our Democratic Party in the House is a little bit gun shy on this subject, as you can readily imagine, just as Congressman Lungren has indicated, that his party is a little bit gun shy, and properly so, on the question of Social Security—any kind of cuts in the safety net of senior citizens as they proceed with this extraordinarily sensitive subject.

But, as between the two Houses of Congress, as between the two parties here, there's a sort of rough and tumble consensus that's been achieved, just as we have achieved a consensus in our society—the broad length and breadth of our society—that taxes must be one of the targets of opportunity, one of the areas in our economy that we must look at.

Now, not many months ago, six former Chairmen of the Council of Economic Advisers, three of them Democratic, three of them Republican, that have sat in that office from 1961 to 1984, with the exception of 3 years in the middle—Walter Heller, Gardner Ackley, Paul McCracken, Alan Greenspan, Charles Schultz, Murray Widenbaum, and Martin Feldstein, as I say, three Democrats, three Republicans—have all said, without any circumlocution, that a hard look at taxes has to be part of the process.

They don't agree on a lot of details, but they say there are four areas that we must look at: reductions in the rate of growth of domestic spending, the mandatory entitlement programs such as Social Security, Medicare. Then, there you've got it; they agree on that.

Reductions in other domestic spending programs, two.

Three, scaling back of the increase in defense expenditures.

And, four, increase in taxes.

Now, they say—they differ on a lot of things, but we don't differ on two essential points. First, we must find a combination that will sharply reduce the prospective deficits to a point where a structural balance in the deficit is at least within reach. And, two, as a practical matter, they say, "It will be difficult to devise an effective policy combination that will meet that goal without some contribution of each of the four elements," including an increase in taxes.

That last phrase is mine, my own.

Now, I'm simply saying here that you arrive here at a point where we're facing up to a condition and not a theory. The President is a very doctrinaire man, and I respect him for that.

And I might say he has made a great contribution to our society in the last 5 years by forcing Members of this Congress, of both parties in both bodies, to do some hard, though, unpleasant things that we didn't do over a 50-year span to remove some of the silliness, some of the waste, some of the ripoff, some of the egregious diseconomies from some of our compassionate programs.

And the President forced us to face up to some of those hard facts, and he's forced us to make some tough decisions. And I respect him for that. He's made a tremendous contribution to our society and to our economy that we, apparently, over a period of a generation, under Presidents of both parties, were incapable of making.

But, here we are, Mr. Secretary. We're faced with a condition and not a theory. The condition is that there is virtually a total consensus in our American society that we've gone about as far down the route as we can in cutting domestic programs; and that we probably ought to think about cutting the military; and we probably ought to think about some increase in taxes.

There are a whole variety of taxes, all the way from value-added taxes to elimination of the tax packaging incentives for real estate development, to gas tax and import tax, energy import tax, and so forth.

But there's a consensus in our country among solid, responsible, thoughtful, effective members of the business community, the economists among us of both parties, Congressmen and Senators of both parties, that the time is now to begin talking about taxes.

And I can tell you, Mr. Secretary, I can go back to my district and play a lot of games and lambast the administration for their insensitivity, the cruelty of this approach, the hurting senior citizens, and so forth.

We don't want to do that. We want to solve the problem. There's been too much demagogy in the past. Congressman Lungren has referred to it; I'm referring to it. Perhaps we've all been guilty of it.

But, it seems to me that now is the time to put that behind us. If we have to move toward a second Gramm-Rudman cut, the results in our country, forgetting about the results to the FBI, the CIA, the Internal Revenue Service, the very basis of Government, you know, Karl Marx talked about the withering away of the State. But the only person whose really done it or approached doing it is Ronald Reagan. [Laughter.]

But we don't want the State to wither away. We think there are certain essential functions, that Government ought to be there.

In terms of the anxiety that we feel among our senior citizens, among our disabled people, among the poor, the crippled, the helpless, the anxiety, the hardship, the toll that this is taking out of their lives, the quality of their lives, it's pitiful and painful and we really ought to stop it and get down to the business of solving this problem of the deficit, and solving the problem of coming to some kind of a national consensus that will be reflected in our Congress, that our Congress is ready and able to do now.

The Senate Republican leadership has made that clear beyond any peradventure.

And I believe the House leadership would follow if they had some indication that they weren't going to be caught in the degrading, demagogic business of whose responsible for tax increase.

There's a lot of decency in this Congress, in the Senate and in the House, a lot of compassion. We want to do the job.

We want to do the job, but we can't do the job that the entire American people want, the best thinkers in our society want unless

we get some leadership from you and from the President on this subject and unless you give some indication that taxes are part of the mix.

Give us some reassurance that we are not going to continue this really destructive process, destructive of the quality of the lives of millions of Americans very much longer.

Secretary BAKER. Congressman, roughly $12 billion or 30 percent of the $38 billion in overall reductions that we are asking for in this budget are revenues of one form or another—an extension of the cigarette tax, user fees of various types.

I really believe that if you add——

Representative SCHEUER. Can you refer to the fact that six ex-Chairmen of the Council of Economic Advisers think we ought to seriously discuss significant tax increases as part of the total mix?

Secretary BAKER. Well, I really don't think that is persuasive. Some of those advisers were suggesting tax increases during the course of his Presidency, and he rejected that advice. I don't see, frankly, any reason why he should accept it now.

I also think that if you go out and ask the American people whether or not they would prefer to see this deficit reduced through an increase in taxes or through reductions in Federal spending, they would overwhelmingly tell you they want to see it done through reductions in Federal spending.

I frankly think that the majority of the American people would support some withering away of the State. I think they think the State is too big. I know the President thinks that the Federal Government is too big.

He campaigned in 1980 and again in 1984 on a platform of shrinking the size of the Federal establishment, and he makes no bones about it. And you can call it doctrinaire or whatever you want.

You were generous in your comments with respect to the contribution he has made, and it is significant. In my view, one reason he has been as successful as he has been is because he has an inner compass. He knows what he believes in, and he is not going to be dissuaded from that by the slightest political wind that blows by.

I have to tell you that the issue of increasing taxes is contrary to the heart and the guts and the soul of the Reagan revolution. It is simply a nonstarter to talk about tax increases.

That was the fundamental central issue in a national election that we have just completed. The President addressed the issue, his opponent addressed the issue, and the President ended up the winner in 49 States.

Representative OBEY. Senator Mattingly.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman.

Now, I know the difference between the two bodies. I am glad I came over for a little self-defense.

In all due respect—I hope none of this makes the evening news, by the way—but I have heard a lot of comments over here in reference to the leadership in the Republican Senate being for a tax increase.

I don't think you will find that is true with the Republicans. I understand what you are trying to do here is dramatize the alleged need for raising taxes. You can nod affirmatively, and I am going to nod negatively because there are those of us in the Senate—as I am sure there are over in the House—that don't think that is a target of opportunity.

It is a target that would defeat the economic growth that we have got going on in the country right now, and I agree with the Secretary of the Treasury—in fact, I think I agree with all the people in the United States that believe a trillion dollar budget is big enough.

The Congress has its duty to go back and reshuffle that trillion dollars wherever they want. But I think a tax increase is totally out of the realm of what the people of our country want. To say that there is a consensus out there that they want a tax increase is patently false, because they don't. The consensus of the United States thinks this place just spends too much money, and they are exactly right.

I think one of the knee jerk reactions that some have about the tax increase shows what both the House and Senate do well is nothing, and hopefully nothing will prevail in reference to a tax increase this year in the Congress.

I would like to ask the Secretary a question. I was just reading in the New York Times this morning that they are talking about how the economists now detect a falling trend in the deficit.

So I don't think we even need to be discussing raising taxes. What we need to do is continue discussing putting a cap on spending and I think the message needs to get out, even by the Secretary that we are really going to spend more money in 1987 than we did in 1986.

Let me ask you this question, Mr. Secretary. In reference to the decline of the price of oil, what impact do you think that is going to have on our Federal budget? What impact do you think that is going to have on the Defense Department as far as the costs? Do you have any idea?

Secretary BAKER. Well, obviously it will generate some savings in fuel outlays as far as Defense is concerned. And, as I mentioned a moment ago—I think before you came in, Senator—the decline in oil prices should overall have a very beneficial effect budgetwise because it should increase growth possibilities in the United States——

Senator MATTINGLY. Right.

Secretary BAKER [continuing]. And for that matter, on balance, around the world.

Senator MATTINGLY. It cuts inflation, but doesn't it cut the costs at the Defense Department?

Secretary BAKER. Yes, sir, it will.

Senator MATTINGLY. And I imagine it is probably an appreciable amount of money, too, wouldn't you think?

Secretary BAKER. I would think so.

Senator MATTINGLY. Well, the other thing is what impact do you think a tax increase would have on our economy?

Secretary BAKER. Well, the President's strongly held view is that any tax increase is a charge against the economy. I agree with the

chairman's chart on the far left over here. I think it is accurate. But I think what——

Senator MATTINGLY. Well, is this position correct on the chart at the far left?

Secretary BAKER. Well, no, I think what we ought to look at is the overall tax charge against the economy. I think raising taxes constitutes a charge against the economy whether they are Social Security taxes or some other kind of tax.

So therefore, I think it is fair and honest and reasonable to suggest that overall revenues are historically about where they have normally been at 19 percent of GNP.

Senator MATTINGLY. In other words, what you are saying is if they raise taxes this increase in private sector jobs of 9 or 10 million in the last 3 years is not going to continue?

Secretary BAKER. Well, I don't know that you can say it won't continue or by how much it would be reduced, but an increase in taxes would likely have a negative effect on the economy.

Senator MATTINGLY. What effect would it have on interest rates?

Secretary BAKER. Well, I am not sure that it wouldn't cause interest rates to rise or increase the likelihood that they might rise.

Senator MATTINGLY. Well, how about inflation? What do you think it would do there?

It is not a plus, is it?

Secretary BAKER. Well, it is not a plus, no. I am not sure that you can——

Senator MATTINGLY. Would a tax increase——

Secretary BAKER [continuing]. Conclude automatically that it would cause an increase in inflation.

Senator MATTINGLY. It is not exactly like sunshine on the economy then, right?

Secretary BAKER. No, sir.

Senator MATTINGLY. Right.

Let me ask you another question in reference to tax amnesty, and I know that Senator D'Amato is probably going to ask you a question in reference to the forgiveness.

Secretary BAKER. OK.

Senator MATTINGLY. Well, I would like when the time comes that you go into that.

Secretary BAKER. I will.

Senator MATTINGLY. I want you to approach it from the point of view of what impact that is going to have on people who pay their taxes, if that was going to be considered.

It seems to me that it might have a negative impact.

Secretary BAKER. Do you want to get into that now, or do you want to wait?

Senator MATTINGLY. No, I will wait. But I just want you to address that from the standpoint of folks like me who pay my taxes regularly. Might that dampen my desire to voluntarily pay my taxes?

Also, you had mentioned before that in the Treasury Department there was an urgent need to make some changes in the currency, primarily because with today's technology the currency is easily counterfeited.

Now, do you have any type of status report on the proposed changes?

You had set a timetable a year or so ago even before you took office in reference to that. I know the House has recently passed some legislation. But do you have anything on that?

Secretary BAKER. The President and I have approved some changes which I would characterize as minor, Senator, in the currency to make it more counterfeit-proof.

Senator MATTINGLY. Well, what are those?

Secretary BAKER. The specifics of those changes will be laid out publicly shortly, to the extent we can do so consistent with security considerations.

Senator MATTINGLY. Do you think it is going to have much of an impact in reference to the illegal drug traffickers?

And that is really what we are trying to get at——

Secretary BAKER. I think it will.

Senator MATTINGLY [continuing]. Is to halt the laundering.

Secretary BAKER. I think it will help us. It will help us considerably in combating counterfeiting.

I am not so sure that the changes we are now suggesting implementing will have all that far reaching an effect with respect to combating drug trafficking. But it should be very helpful with respect to counterfeiting, and sometimes the two are related. We are continuing, by the way, to study other possible changes.

Senator MATTINGLY. Well, is there any more thought being given to changing the currency other than just changing some of the——

Secretary BAKER. Well, we will be announcing, to the extent that we can do so, the specifics of the changes that have been approved.

Senator MATTINGLY. How soon do you expect that?

Secretary BAKER. Very shortly.

Senator MATTINGLY. Shorter than what it was last year?

Secretary BAKER. Let me say this, Senator Mattingly. I don't think you or anybody else would find those changes to be dramatic or offensive in any way. We are continuing to study some more far-reaching suggestions.

Senator MATTINGLY. Mr. Chairman, I am finished.

Representative OBEY. Thank you, Senator.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman, and it is good to see my friend, Secretary Baker, here.

I have a full opening statement, Mr. Chairman, that I would like to be entered into the record in its entirety in order to save some time.

[The written opening statement of Senator D'Amato follows:]

WRITTEN OPENING STATEMENT OF SENATOR D'AMATO

THANK YOU, MR. CHAIRMAN. BEFORE WE BEGIN, I WOULD LIKE TO THANK SECRETARY OF THE TREASURY, JAMES BAKER, FOR TESTIFYING TODAY ON THE ECONOMIC REPORT OF THE PRESIDENT. I LOOK FORWARD TO HIS COMMENTS.

THE ACCOMPLISHMENTS OF THIS ADMINISTRATION CONTINUE TO IMPRESS ME. WHEN I ENTERED THE SENATE FIVE YEARS AGO, I KNEW THAT, WITH A DETERMINED EFFORT, THIS ECONOMY COULD BE PUT BACK ON ITS FEET. THE FIGURES NOW SHOW OUTSTANDING SUCCESS.

UNEMPLOYMENT IS AT ITS LOWEST POINT SINCE APRIL 1980, 6.9 PERCENT. FIVE YEARS AGO, UNEMPLOYMENT WAS 7.6 PERCENT.

INFLATION, AS MEASURED BY THE CONSUMER PRICE INDEX, ROSE ONLY 3.6 PERCENT DURING 1985. INFLATION FIVE YEARS AGO WAS AN ASTOUNDING 12.4 PERCENT.

THE PRIME RATE IS A LOW 9.5 PERCENT, THE AVERAGE PRIME RATE FOR 1981 WAS AN INCREDIBLE 18.87 PERCENT. WHEN THE

PRIME RATE IS DOWN, HOME SALES AND HOME BUILDING ARE UP. WHEN THE PRIME RATE IS DOWN, AUTO AND TRUCK SALES ARE UP. BOTH HOME SALES AND AUTO SALES REACHED SEVEN-YEAR HIGHS IN 1985.

THESE CONDITIONS POINT TO A PROMISING ECONOMIC FUTURE.

THERE IS, HOWEVER, ONE CLOUD WHICH HANGS OVER THE FUTURE OF THE ECONOMY. THAT CLOUD IS TAX REFORM. WHILE THERE MAY BE SOME DISAGREEMENT OVER WHAT EFFECT TAX REFORM WILL HAVE ON THE ECONOMY, THERE IS NO DOUBT IN MY MIND THAT, AS IT WAS PASSED BY THE HOUSE LAST DECEMBER, IT WILL HAVE A DEVASTATING EFFECT ON CAPITAL FORMATION ACROSS THE COUNTRY.

THIS, SO-CALLED TAX-REFORM BILL WOULD LIMIT MANY OF THE TAX INCENTIVES THAT HAVE ENCOURAGED INVESTMENT IN DURABLE GOODS AND HAVE PROMOTED CAPITAL FORMATION. THESE PROVISIONS WERE THE HEART OF THE 1981 REAGAN REVOLUTION FOR ECONOMIC EXPANSION. THE SAME EXPANSION THAT GAVE US ALL THE GOOD NUMBERS I JUST CITED. BY ENCOURAGING NEW INVESTMENT THROUGH ACCELERATED CAPITAL COST RECOVERY, INVESTMENT TAX CREDITS, AND OTHER SUCH PROGRAMS, INFLATION WAS REDUCED AND NEW JOBS WERE CREATED. NOW THAT THIS PROCESS HAS JUST BEGUN TO TAKE EFFECT, TO REPEAL MANY OF THE TAX PREFERENCES GIVEN CAPITAL FORMATION WOULD BE DEVASTATING TO OUR ECONOMY.

I BELIEVE THE SENATE WILL PRODUCE A TAX-REFORM BILL. I HOPE, HOWEVER, THAT THE SENATE, BEFORE IT PASSES SUCH A BILL, WILL CORRECT THE INEQUITIES WITH RESPECT TO PROVISIONS THAT WERE RESPONSIBLE FOR THIS GREAT ECONOMIC TURNAROUND.

I AM CONFIDENT THAT THE ECONOMY WILL CONTINUE TO GROW, AND I BELIEVE THE FUTURE IS BRIGHT. I ALSO BELIEVE, HOWEVER, THAT WE MUST RESPECT THE FACTORS THAT BROUGHT THE ECONOMY TO WHERE IT IS TODAY AND NOT MAKE ILL-ADVISED CHANGES THAT WILL ONLY SERVE TO SLOW DOWN -- OR EVEN REVERSE -- OUR ECONOMIC RECOVERY.

THANK YOU, MR. CHAIRMAN.

Senator D'AMATO. Basically, what my statement infers, Mr. Secretary, is that we have come a long, long way in the past 5 years. Notwithstanding the criticisms of Reaganomics—and reasonable people might disagree as to how best we could handle the economy—when we look at the record, the record is an impressive one.

I recall in 1980 and 1981 the runaway inflation that we had, that the American people felt, and I look now and I see much improved interest rates. I also see inflation rates cut dramatically from highs of 12.5 and 13 percent down to the 3 to 4 percent level.

I recall not only inflation, but also the ravages of inflation and those prime interest rates that, at one point, hit 21.5 percent. Now we see them coming down.

I think the Federal Reserve—I would ask you to comment on this—could be a little more helpful. It seems that we are entering into a bipartisan—I think it is bipartisan—spirit of attempting to reduce the deficits by cutting spending—with reference to Gramm-Rudman. That was supported in the Senate with more than 50 percent of the Democrats voting for it. What we are saying is that in the next 5 years, let's balance the budget.

That makes some good sense to me, and I would hope that the Federal Reserve would look to lowering the discount rate to help this, because the ravages of inflation are not there any more. We are not going to be fueling that, but I think we will be fueling a surge in the economy.

Having said that, I would ask you to respond to that one statement on my part.

Senator Dixon and I are sponsoring legislation, a Federal tax amnesty program, which I believe is a thoughtful approach to raising revenues. It gives people who have not paid their taxes an opportunity to do so. These are people who would like to pay taxes but who are fearful because once they are out of the pattern of paying taxes, whether it is not paying anything or paying a very insignificant part of what they should be, they are almost trapped in the cycle to continue not paying for fear of prosecution.

Now, some of the latest tax amnesty States, or States that have undertaken this initiative, have had tremendous success, my State of New York included, where initially the Governor shared a certain reservation that I think some of the officials in Treasury have had over the years and that my colleague, Senator Mattingly, who has left, expressed.

What will that do for the future? Are you encouraging people not to pay taxes in the future?

One of the things our bill does is spell out specifically that this is a one-time amnesty.

Second, in terms of collection, we call for 3,000 additional IRS agents to be brought into the picture.

Third, we increase penalties dramatically after the amnesty provision period for those who fail to pay their taxes, et cetera. This is to dissuade people from not paying their taxes.

I don't think there has been a definitive study on this in quite a while, and I understand you may be undertaking one.

Should we really be looking at this closely as a way of raising anywhere from $15 billion up, and wouldn't that be a significant revenue enhancer, without raising revenues, to help reduce the def-

icit, helping us to get to that Gramm-Rudman target of about $144 billion for 1987?

What are your thoughts on that?

Secretary BAKER. Well, clearly, Senator, we should be looking at it closely and carefully, and we are doing just that, as you and Senator Dixon have requested that we do.

There could well be some short-term benefit along the lines that you have mentioned. The amount could, I suppose, be subject to dispute.

It is the view of the IRS and our tax policy people that Federal compliance is, generally speaking, better than State compliance has been in some of the States that have had a good experience with a tax amnesty program. The reservation with respect to tax amnesty at the Federal level has always been that you send the wrong signal to the voluntary complier. Our tax system depends in large part on voluntary compliance, and we have enjoyed a fair amount of that, we think.

Contrary to stating that it is a one-time thing, people could get the impression that every few years there will be an amnesty program. Clearly that should not be contemplated, and no such signal should ever be sent.

The bottom line is we are looking carefully at it, and it is very much worth considering.

Thank you, Mr. Secretary. One further question, Mr. Chairman.

Again, Mr. Secretary, I have a feeling that as we have so many good things going our way—particularly regarding inflation, with the cost of energy coming down—that means a tremendous savings not only to the consumers at the retail level in terms of our home heating bills and at the gas pumps, but also in terms of production and industry, especially the synthetic industry, so much of whose raw materials come from the fuel base. This hopefully is going to have a very salutary effect on lowering costs.

Do you anticipate the Fed doing anything in response to that; in other words, lowering the discount rate?

Secretary BAKER. Well, I don't think it would be productive for me to make a guess here today one way or the other on that other than to say this: Contrary to some reports, there is no difference of opinion between the Treasury and the Federal Reserve with respect to the desirability of lowering interest rates, if we can do so in a way consistent with preserving the gains which we have made against inflation.

I said that yesterday before the House Budget Committee, and I have said further, with respect to the question of a discount rate reduction internationally, that it was our view that some other countries, who were not projecting as good growth as the United States, who were projecting perhaps better inflation results than the United States, and whose currencies were strengthening rather than declining, should lead the charge if there was going to be such an undertaking.

Let me leave the answer at that.

Senator D'AMATO. OK.

Mr. Chairman, I would like to leave the committee with the thought that in the near future we might hold a hearing with respect to examining the possibilities of the tax amnesty provision

and what it should or shouldn't do, particularly after Secretary Baker completes his study. That might be a very worthwhile endeavor. I think it has some very real potential.

Senator Dixon and I have been working on this bill. He has drafted what I consider to be an excellent piece of legislation that deals with many of the pitfalls that heretofore are the concerns that have been expressed by people in the Treasury and by others about whether tax compliance is encouraged or not as a result of this.

It might be something worthy of this committee's consideration.

Thank you.

Representative OBEY. Thank you, Senator.

Mr. Secretary, let me ask some questions on another subject, trade. As you know, this administration is well known, and the President is well known for holding very hard to a negotiating position, sticking to its guns ideologically and other ways until the bitter end. And then adopting a compromising position if it's necessary, or adopting what some might say would be a more pragmatic stance if it is required.

And it seems to me that the latest example of that is the change in position on currency intervention that came out of the group 5 meetings that you led in September.

Until then, as you know, the official position of the administration was that currency intervention would occur only to correct the disorderly market.

Then, on September 23, under your leadership, we learned that the administration was now taking a more activist position to deal with the problem.

Some would say that, welcome as that leadership was, especially on your part, that it was unfortunate that the change in the administration posture came as late as it did and that because the change came so late, significant damage was done to the economy.

I have two Commerce Department staff studies which document, at least in their view, the damage done to the economy.

The first, entitled "Employment Effects of U.S. International Trade Changes," estimates that growth in the trade deficit between 1980 and 1984 cost the economy about a little over 1 million jobs, 1.1 million jobs, in exporting industries; 700,000 jobs in import competing industries; and raised the unemployment rate by 1.1 percent.

The other study, titled "Trade Ripples Across U.S. Industries," had even more drastic conclusions. They indicated that their estimate was that the trade deficit of 1984 cost the economy between $60 and $90 billion in lost output and between 1.1 and 2.4 million jobs, with most of that job loss occurring in manufacturing.

I know there are a lot of debates about the degree to which that trade deficit actually did cost jobs. But I guess what I would ask is:

Why did the administration wait until September? I don't say that to criticize you because I think that you provided a change in leadership for the better.

But why did it take so long before the administration decided to act to change its policies and agreeing on a program to bring down the dollar?

Secretary BAKER. Well, I think, Mr. Chairman, that it was important that we not move before there was a consensus within the G-5, that any movement on our part would be successful.

And that's what we did. Now I can really only speak about the period from the time that I came to Treasury, in February. To the extent that it represented a change in policy, you had to accomplish that change in policy. I've argued that it was, to a large degree, building upon policy. If you look at the communique that was issued at the Williamsburg summit, we said that intervention was a proper policy tool and it would be used when to do so would be helpful.

If you want to take the position that it was a major policy change, fine. It took some time to implement—to get agreement to that change. But, the key thing, in my opinion, was not to move before we had reason to believe that a movement would be successful.

Representative OBEY. Mr. Secretary, maybe that's the answer.

I guess my instincts tell me that maybe that's part of the answer. I also suspect that there's something else that's part of the answer; because I do think that it's been the style of the President and the administration to hold to an ideological position until facts force them to move.

And, frankly, I think that's exactly what's happening on the budget situation now. The reason I asked that question is because I think that the delay that cost us a lot of economic pain on the manufacturing side, a delay which I think was unfortunate, is a delay which we're also experiencing on the domestic side in terms of our own budget deficit right now.

Secretary BAKER. If you're suggesting, Mr. Chairman, that the rise in protectionist pressures on the Hill contributed to it, I would certainly not disagree with that.

Representative OBEY. Well, let me ask you, what is your estimate for the trade deficit for—what do you think the trade deficit is going to reach by the end of 1986, on an annual basis? Mr. Sprinkel expected that it would still rise?

Secretary BAKER. Well, I think that we're going to be running a deficit, clearly. Estimating the trade balance is not my particular responsibility——

Representative OBEY. I understand.

Secretary BAKER. I do believe that we're going to begin, as my prepared statement indicated, to see some good results in terms of a lowering of the amount of that deficit.

We're going to be, in effect, if you will, heading up the J-curve sometime later this year. I'm not sure that anybody knows exactly when that's going to occur.

Normally, I'm told, it takes 12 to 18 months after changes in the exchange rate before you see the effect in the trade figures.

I'd like to add one other thing. I spoke to a business group that was here in town last night. They, and others, have told me over recent weeks that they are beginning to see signs of change in terms of orders and sales, and that sort of thing.

Representative OBEY. But you agree with Mr. Sprinkel that it still, for this year, will probably be higher than it was last year?

Secretary BAKER. Well, I think it's important to note that Mr. Sprinkel's estimate is based on an out of date oil price figure, of course, and he would be the first to acknowledge that.

But if your question is, Will it still be in deficit this year?

Representative OBEY. Oh, no, I think everybody knows it will be in deficit this year.

Secretary BAKER. What is your question?

Representative OBEY. I just was wondering what number you thought it would total up to by the end of the year?

Secretary BAKER. Oh, I can't say. I don't have a crystal ball that would tell me that.

Representative OBEY. OK. Let me return to the Federal deficit issue, and resume the point I was making in terms of the reluctance of the administration to wait until the last minute to cut a deal on this as well as on the trade deficit.

George Will indicated in one of his columns that the Reagan administration, in terms of the way it deals with deficits, is suffering from delusions of adequacy.

You indicate that you really think that if you follow the President's budget, that we're going to get to that deficit, wipe it out. You point to CBO's numbers.

I would simply ask you this. The President's budget assumes that we're going to grow at 4 percent. Let me ask you what would the deficit be, in your judgment, in 1991 if we grew at the average rate of growth that we've experienced the last 5 years, which is roughly 2.5 percent, rather than growing at 5 percent or at 4 percent for each of the next 5 years, which would be unprecedented in our economic history?

Secretary BAKER. For each percentage point of growth that you lose, Congressman, I'm told receipts would be lower by some $60 billion by 1991. I haven't made that computation myself, but that's what I'm told.

Representative OBEY. So you're saying that—I think what you're saying is that if the economy grew 1 percent more slowly than you said.

Secretary BAKER. Slower, over the period.

Representative OBEY. Over that period. So, if it were 3 percent instead of 4 percent?

Secretary BAKER. It would take roughly $60 billion out of receipts.

Representative OBEY. That we would be left with a deficit of $60 billion.

Secretary BAKER. That's right, although the deficit would be greater if unemployment were also higher, causing a rise in outlays.

Representative OBEY. And so I could extrapolate from that, I assume, that if we grew at 2.5 percent, which is the rate that we've grown over the last 5 years——

Secretary BAKER. The deficit would be $90 billion or so.

Representative OBEY. It would be about $90 billion.

Secretary BAKER. Higher.

So it would be, well, I guess from that you could assume the deficit in 1991 would be $90 billion, which of course would be well under 2 percent of GNP.

Representative OBEY. Well, but it wouldn't be in compliance with Gramm-Rudman.

Secretary BAKER. No, sir; the Federal budget would not be balanced.

Representative OBEY. That's the point I'm trying to make. What we are told is that we're supposed to rely on the administration's budget, which is strictly a domestic reduction budget, not a spending reduction budget across the board. But just a domestic reduction budget.

And we're told that we're going to get there without any additional reliance on revenues, and we don't have to cut defense either because we'll still get there.

But that's based on an assumption that we will experience a rate of growth that we haven't experienced for that period of time in postwar history.

And I think that's a mighty shaky reed upon which to base any budgetary judgments.

Mr. Secretary, I don't want to keep you much longer, but I do want to make a couple of observations. And I know Congressman Scheuer has a couple of questions.

You indicated that when the public is asked whether they want the deficit to be reduced by raising taxes or by cutting spending, they say they want it reduced by cutting spending. Unquestionably, that's what they say, because I think when you put it that way, they think you're talking about increasing individual income taxes.

But I think if you asked them if they would prefer to see the budget balanced by using revenues which we pick up from minimum tax on corporations and individuals who, up to now, are paying no taxes; or if they want to see that budget balanced exclusively by cutting cancer research, cutting heart disease research, cutting student aid, transportation, cutting sewage treatment plants, I think you get a quite different answer.

At least, I certainly do on my polls.

Secretary BAKER. You do?

Representative OBEY. And I think it is important for people to understand that there is no human being who I know in the Democratic Party or the Republican Party on Capitol Hill, who is talking about increasing the income tax rate in order to solve the deficit problem.

What we are saying is that there are a wide variety, there's a wide range of revenue opportunities which are out there if we have sense enough to use them. And coupled with a round the horn sharing of budget reductions, you can get to a deficit level that we're required to get to in a much more reasonable fashion.

That's what we're saying. And we're saying that the sooner we get there, the sooner we get that negotiating going on, the better off we are.

We're not going to get it. I know what's going to happen. The Budget Committee will put the President's budget up. That will go down. Then we'll put ours up and it won't be supported by the President and the Senate.

And sometime, along about October, we'll face another last-minute fire drill and look as stupid as we did last October in the process.

But I really hope that that could be avoided by earlier negotiating. And I'd simply suggest that if it can't, if the administration does insist on sticking to its no revenue of any kind position, I'm perfectly prepared to live with Gramm-Rudman. My understanding is if you had a straight outlay freeze across the board on every program, you would be about $12 billion short still of where you needed to be under Gramm-Rudman, assuming moderate economic growth.

And that means that you would have to share the cuts fairly. If you were going to deal only in the spending side, you would have to include everything from defense to special milk program for a reduction in outlays across the board.

And I'm perfectly willing to live with that. And if we can't get it, I'm perfectly willing to live with Gramm-Rudman. And I honestly think most Members of the House are.

And if the President prefers to have that scenario played out, then we ought to keep going down the road we're going now, which is continuing to put out our baloney press releases about no compromise.

But the sooner those mimeograph machines stop and the sooner the negotiations start, the better off the economy is going to be. The better off the taxpayer is going to be.

Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Well, you've been dilating on the same subject that I was addressing. I have a rather lengthy question, and I apologize for its length, but it's one that concerns us all.

And, you know, the American public doesn't really distinguish too much between the Congress and the executive branch. They look at Government, and they feel that things are out of control and that Government is not doing its job.

And that diminishes us all. All of us who are trying to do our job, and you have an exceptionally important job to do and you're an enormously talented and devoted, dedicated man, and you're giving it your level best. And we all respect that.

We're doing the same.

And to me, it's a tragedy that we're all being demeaned and degraded in the public eye as simply not measuring up to our responsibilities and coming up with answers.

Now, the President, I have to tell you, is—I don't know if it's a confidential matter—he doesn't have to run again. And I also have to tell you that the public distinguishes between the President as a nice guy—whom we all know is a nice guy, we've all met him. And we all admire him. He's a marvelously likeable human being.

And the public distinguishes between him and his programs. We know that. Otherwise, he wouldn't have lost these 26 members of Congress that Dan Lungren referred to.

The President has asked the American people to give him a House and a Senate and they have answered in unmistakable terms—they like him as a nice guy. They trust him. He's made them feel good. He's made us all feel good. And I'm proud of our President.

But they don't like a lot of his policies, and they like the idea of the two-party system working. And we want the two-party system to work. And we want our tripartite form of Government to work.

And it isn't working when there isn't a little grease in the machinery. When the machinery isn't oiled sufficiently so that there isn't some give and take and solid respect for the views of the other branch, especially between the legislative and the executive branch.

And, as I say, the President stands isolated from his own party, from the other governing branch of office and from important spokesmen, from all segments of the responsible business, banking, economic community.

And it's doing damage to Government. It's doing damage to your credibility, to my credibility, to Dave Obey's credibility, to Dan Lungren's credibility—all of us are being demeaned by the public view that we simply can't get our act together.

And we simply know that there will be some movement and the President will begin to look at the overwhelming consensus that's been achieved in this country, a country that's waiting on him to join in a team effort, a collaborative, cooperative effort.

I'm not going to ask you to answer that unless you want to.

I have a question on taxes. In my prior incarnation, I was a developer, and I was one of those awful people that we call tax packagers, and I built a whole lot of projects around the country, commercial, office, residential, and I could—now this goes back to the late 1950's and early 1960's—I could prove to a potential investor, with his accountant and his tax lawyer sitting by his side, that he would get back his capital investment in these projects before the first tenant moved in, from the depreciation during a 2-year construction loan period and from the deductions, from other deductions, depreciation and interest deductions, primarily.

Secretary BAKER. And if the project went under, he would suffer no loss, because he wasn't at risk.

Representative SCHEUER. That's right. I was at risk, because I had to put up the architectural and engineering moneys, until the start of construction, but I generally got that back after the first construction draw.

Secretary BAKER. Right.

Representative SCHEUER. So if construction started, I was home free on the advances I had made, which were very substantial. Frankly, I never had a project go under, and I built projects from Puerto Rico to California. I never had a project go under. And many of them enjoyed Federal guarantees of one kind or another, the Federal Government was well served by this program. And a lot of projects got built, especially in the area of low-income housing, slum clearance projects, that were very risky, which free enterprise wouldn't have taken, if they hadn't had these incentives.

Now I suggest to you that the granddaddy of them all was the old 608 Program. I don't know how Dave Obey fared when he got out of the service, but I tell you there are many Members of this Congress who got out of the service, no housing was available. They were doubling up living with their in-laws, and then came the 608 Program that promised developers a borrow-out deal, where the FHA actually went to them and said, you build, we'll give you a

mortgage of a little over your costs, so you will walk away with a 10-percent profit and you will own the equity. And millions of veterans in the late 1940's and early 1950's were able to move out from their in-laws and save marriages. [Laughter.]

Because of this Federal program.

Ten years later, or a decade or so later, we sort of changed the ground rules, and we began to look back at these programs and say, oh, my goodness, this man actually walked away with a profit! The Federal Government insured a mortgage 10 percent higher than its costs. But people forget the environment in which that was done, to save those marriages and help those veterans find housing on their own, and that the FHA held out the incentive of more than a buy-out loan that a developer could take, put it in his pocket and have the equity as his profit.

Now that is a matter of public policy for the Congress and the FHA to determine. And I think it was a wonderful program. I think these programs that I developed over a period of a decade or so and the many other developers, it worked good. They weren't harmful. And they built a lot of apartments and hotels and office buildings and apartment houses that wouldn't have been built otherwise. Well, a lot of them would have been built otherwise, but maybe they wouldn't have been built quite as soon.

But today, I have to wonder whether we should continue offering that kind of incentive to real estate, which is a sheltered industry in terms of foreign competition. Hotels and apartments and office buildings and shopping centers compete with each other, but they don't compete with the Japanese or the West Germans or the Swedes. In effect, they are sheltered from foreign competition, whereas our whole production economy, the smokestack industries, our high-technology industries on the west coast and elsewhere, were in desperate competition in global commerce and are barely keeping their lip above water. And we discussed before, whole industries are being almost wiped out systematically, shrinking, because they can't compete in global trade, to some extent due, of course, to the overvalued dollar, which has come down about 30 percent in the last matter of months, which is marvelous.

It seems to me we ought to be offering incentives, in terms of accelerated depreciation and investment tax credits, primarily to the productive sector of our economy. Whatever we think we can afford to give to the business community, as a total community, in terms of incentives to get out there and hustle, to developers like me, whatever incentives you can afford—our society can afford to give to developers to get out there and produce, it seems to me, we ought to tell them to produce, in terms of more research and development for our industrial sector, improve plant and equipment for our industrial sector, so we don't try to compete with the global steel industry with antiquated steel mills that are obsolete, totally inadequate, and uneconomic, and we have perhaps less of a priority to give enormous tax incentives to hotels, apartments, shopping centers, office buildings, which, while laudable, aren't really a critical high priority with our country.

And it seems to me that when we diddle about with investment tax credits and with accelerated depreciation, rather than do it on an undifferentiated basis, mightn't it make sense to differentiate

between these sheltered industries, mostly real estate, and the industries, the production industries that are in intense, bitter competition for survival commerce, and say:

Hey, look, all of you developers, if you want these very substantial incentives, get in there and hustle in helping America be an effective, economic, strong, tough global competitor in industrial commerce and perhaps not provide such generous incentives. The things that we really don't need half as badly as we need to bring our industrial plant up to scratch.

Secretary BAKER. Congressman, we did so differentiate in the Treasury II proposal, which we submitted. Unfortunately, the House did not differentiate as much in H.R. 3838, which ultimately passed. As you know, while the President supported passage of that bill, he indicated he couldn't sign it in its present form. One reason he couldn't was for the one that you pointed out: the cost recovery provisions were simply not adequate to support those types of industries and manufacturing businesses that you spoke about.

We took a big cut at the real estate shelters. The House preserved many of those reductions, though not all. But it also violated in the worst way, we believe, the capital cost recovery provisions of the President's tax proposal, and that is one of the major items that we want to see corrected in the Senate. It is important that we have incentives for investment. It is important that we have capital formation. And it is important that our industries be internationally competitive.

Under the depreciation proposal in the President's tax package, the cost of capital would have been lower on an overall basis than under current law. That is not the case under H.R. 3838, and that is one of the major corrections we seek to make in the Senate.

Representative SCHEUER. Well, I certainly would encourage that, and I would support that. I hope that becomes a reality in our commercial and industrial life.

Thank you, Mr. Chairman.

Representative OBEY. Thank you, Congressman Scheuer.

Mr. Secretary, I just, in closing, would like to draw your attention to page 74 of the CBO's report, "Economic and Budget Outlook," wherein they point out that "Discretionary nondefense spending as a share of GNP is now virtually identical to its level in 1962 before any Great Society spending began," which means that that whole bubble has been eliminated, and in fact, the CBO baseline projection shows domestic or nondefense discretionary spending, declining to 3.4 percent under their baseline projections, even before the President's budget this year. Even before the President's budget is taken into account, it shows that domestic discretionary programs will decline to 3.4 percent of GNP by 1991, in comparision to 5.8 percent as late as 1980, which is about a 40-percent reduction, and I think indicates that, although there may be a few drops left in that turnip, we'd better look at a lot of turnips that the President is putting off budget or off the table, if we are going to really reach the deficit reduction upon which those future economic projections are based.

Secretary BAKER. Mr. Chairman, if I remember correctly, and I can't read that chart from here, but your number was $110 billion. My number is $418 billion. The difference is, I believe, that you're talking only about discretionary spending, and I am talking about

domestic program spending, except for Social Security and interest payments.

Representative OBEY. Well, I would point out that your statement doesn't just talk about saving Social Security. Your statement talks about maintaining the social safety net, including Social Security and entitlement programs.

Secretary BAKER. Well, certainly a 5-percent reduction doesn't eliminate those. I mean, it's not——

Representative OBEY. My point is, what you have left to go after. After you exclude senior citizens and welfare, if you exclude from the domestic programs, every program that goes to somebody who is either above 65 or disabled, or if you exclude the roughly 5½ percent that goes to the nonelderly poor, and you know what the deal is in this country. If you are 65 years of age, plus one day, you're a "sainted senior," and if you're 65 years of age minus one day, you're a welfare bum.

I mean, that's the unfortunate distinction we draw in this society. And what I am saying is that we have placed programs of that nature in that blue piece and in that green piece, and that means that everything else that there is in the economy, what I consider the investment portion of the budget, the portion that decides whether we are going to have a competitive work force, whether we are going to have competitive research, whether we are going to have a competitive set of communities or functioning communities, in which business can make a buck and labor can make a dollar——

Secretary BAKER. You've got Medicare and Medicaid, I suppose, over there in the blue.

Representative OBEY. That's correct.

Secretary BAKER. See, my view is that a 5-percent——

Representative OBEY. Well, Medicare, no. Medicare is in the blue. Medicaid is not.

Secretary BAKER. Uh-hum. I was trying to determine the difference between your $110 billion and my $418 billion, and I think the difference is your are restricting it purely to discretionary programs. I am talking about all domestic spending programs, except Social Security and interest, and I don't think, in talking about those, that it is inconsistent with what I say in my statement.

Representative OBEY. I understand what you are saying. My only point is that—forgetting your chart and forgetting mine, the fact is, you are concentrating most of the President's reduction in that portion of the budget which Rudy Penner has described as having been reduced by 40 percent since 1980. And with all due respect, I would be perfectly willing to put that proposition on the floor today and see if you can get 25 percent of the people in your party to vote for it. I don't think you can, which means we really ought to start dealing.

Representative SCHEUER. Mr. Secretary, you and Chairman Volcker have been up to the Hill, and in the last 48 hours, you have had different positions on the desirability of further reductions of the value of the dollar.

You have testified before committees on the Hill that you would like to see a further reduction over the 30 percent, more or less, that you have achieved in the last few months. And Chairman

Volcker has testified that he thinks it is about right. And, of course, this is an extremely important consideration, because any further reductions in the value of the dollar would further enhance the ability of American industry to compete overseas successfully and either give them a competitive advantage or perhaps better stated, reduce the competitive disadvantage under which they have been functioning.

Now I would like to ask you what accounts for the difference in your position and Chairman Volcker's. Have you made any efforts to sort of harmonize your views with the Chairman, and if you can't achieve some kind of modus operandi with him, is there any way that you can achieve it further through the monetary, fiscal, and tax resources at your control.

Secretary BAKER. Congressman Scheuer, let me answer that by saying that, as you well know, the Federal Reserve and the Treasury were jointly engaged in the G–5 exercise. The Federal Reserve supported it enthusiastically all along. I don't think that there is a fundamental difference between us on this issue at all. I think what you've seen is a desire for some to rush to judgment.

Let me tell you exactly and carefully, what the Treasury's position is on this, and what my position is.

We would not be displeased to see a further orderly, gradual decline in the dollar, provided that it was in response to normal market forces. I think my prepared statement makes the point with respect to the consequences for inflation that a lower currency brings.

I have been, throughout this exercise, since the 22d of September, very careful to say that nobody wants to see a dramatic or precipitous drop in our currency. Clearly, nobody wants to see a free fall. Clearly, nobody wants to see an erosion of confidence. But that is not inconsistent with saying that if normal market forces operate to gradually lower the value of the dollar over a period of time, we would not view the decline with disfavor or alarm.

Let me say one final thing that I have said consistently, and I think is important for people to understand.

We do not have a target for the dollar. I think, without putting words in his mouth, that the Chairman of the Federal Reserve Board would agree with that. Therefore, you cannot say this is where it ought to stop or that's where it ought to stop. I think if you look at his remarks yesterday, you will see that he said, the dollar has "fallen enough," in the sense that it has fallen pretty far, and we would not like to see a free fall or a precipitous drop. Clearly, we agree with that.

So I don't think that the two statements were in any way inconsistent. What I think you saw was a preliminary report on my statement hit the wire, and then the report on his hit the wire, and then you saw the market react.

Representative SCHEUER. I agree with that.

Secretary BAKER. So let me just say one final thing.

Clearly, some of our trading partners may feel that the dollar has gone far enough. They may not like to see their currencies strengthen any further against the dollar. That's their view. They are entitled to it. We would respect their view. But when I say we would respect it, that doesn't mean we would necessarily do any-

thing about it. We would respect their right to have their own view regarding the value of their currency.

Representative SCHEUER. Well, it is more than having their own view. Rumor has it that the Japanese, for example, are very concerned about the rising value of the yen, vis-a-vis the dollar, and that they are prepared to intervene to support the dollar and to prevent any further decline, which would continue to eliminate some of the competitive disadvantage which our people—competitors have been under and which would tend, if they can stop any further decline of the dollar, that would tend to perpetuate the very unfair trading advantage that they have benefited from.

Now if they actually intervene, if they aren't happy with the automatic workings of market forces that you have described, if they actually intervene to support the dollar, and to prevent this gradual orderly reduction of the dollar, which would enhance the competitive position of the vast array of American competitors with Japan, what would the reaction of our administration be?

Secretary BAKER. Well, I think you are asking me whether we would seek to counteract that in some way, or whether we would seek to intervene ourselves. And our policy, Congressman, as you can well appreciate, is not to comment with respect to that, and particularly, with respect to hypothetical press reports about what they might or might not do. I am sure you can understand why I wouldn't be able to get into speculation with you about that.

Representative SCHEUER. I thank you very much, Mr. Secretary.

Secretary BAKER. Yes, sir.

Representative SCHEUER. I thank the chairman.

Representative OBEY. Mr. Secretary, just to revisit these charts one more time, so that you understand what it is that I am trying to drive home with them. It is not that I am trying to play games or prove a point or that your way of looking at the budget is not legitimate. My point is simply that when we talk traditionally about the budget up here, we talk in terms that nobody out on Main Street understands or cares about. They don't care about payments to individuals. They don't care about entitlements. They want to know who gets what. And they want to know what all this spending is going to do for the country down the line. They don't care about our nice budgetary titles.

So we simply tried to regroup these programs to demonstrate that if we follow your budget to a T, even if we make all of the cuts that you are talking about in Medicare, in Medicaid, all of those, those cuts are all wrapped into that second circle down there. They are already wrapped in. They are already taken into account. And all we are trying to demonstrate, Mr. Secretary, is that if you do what we have done for the last 5 years, and then do what you suggest that we do this year, that in the main, even with all of the cuts you have proposed for Medicare and Medicaid, et cetera, you will not have increased that blue piece of that pie by one penny, in terms of the cents on the dollar out of every tax dollar that goes to it under the budget.

You will have reduced welfare programs only by about 1½ cents out of every dollar, but what you will have reduced is what I referred to as the investment portion of the budget. You will have

cut that about in half over a 6-year period of time. And that is your budget there. That's not mine.

Secretary BAKER. Uh-hum.

Representative OBEY. And the point I'm trying to drive home, is that if we are concerned about not having a trade deficit, if we are concerned about having companies that are competitive, if we are concerned about having workers that are competitive in quality with Japanese and Germans, you name it, if we are concerned about being ahead of the curve on research, if we are concerned about having the kind of public investments necessary to posture us to compete economically over the remainder of this century, we are concentrating most of the budget cuts in the portion of the budget that provides those investments.

That is what I am trying to demonstrate by that chart, and that is why I think in the end your budget isn't going to fly in Congress in your own party, any more than it is going to fly on our side, and why we need something beside rhetoric now.

Thank you very much.

Secretary BAKER. Thank you, Mr. Chairman.

Representative OBEY. The committee stands adjourned.

[Whereupon, at 12:07 p.m., the committee adjourned, subject to the call of the Chair.]

○